UNITED STATES TAX COURT

BANK OF NEW YORK MELLON CORPORATION, as successor in interest to THE BANK OF NEW YORK COMPANY, INC.,	)	
Petitioner,	)	
v.	)	Docket No. 26683-09
	)	Judge Kroupa
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

RESPONDENT'S TRIAL MEMORANDUM

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RESPONDENT'S TRIAL MEMORANDUM

ISSUES FOR TRIAL

1. Whether Respondent properly disallowed foreign tax credits that Petitioner (also referred to as "BNY") claimed from the STARS Transaction in the amounts of $98,607,973 and $100,285,767 for the 2001 and 2002 tax years, respectively.

2. Whether Respondent properly determined that the income attributed to the BNY STARS Trust is U.S. source income rather than foreign source income.

3. Whether Respondent properly adjusted Petitioner's interest expense to disallow amounts that Petitioner deducted as interest expense from the STARS Transaction in the amounts of $4,030,234 and $31,473,794 for the 2001 and 2002 tax years, respectively.

4. Whether Respondent properly disallowed transaction expenses from the STARS Transaction in the amounts of $835,100 and $6,753,720 for the 2001 and 2002 tax years, respectively.

5. Whether U.K. tax payments by the BNY STARS Trust are deductible under I.R.C. §§ 162, 163 or 164 if the Court determines that the credits that Petitioner claimed for these payments were properly disallowed.

To rule on these issues, the Court must decide whether the STARS Transaction in its entirety, or, alternatively, the trust structure component of STARS that generated the disputed foreign tax credits, was properly disregarded by Respondent as lacking economic substance and business purpose. Alternatively, the Court must decide whether the foreign tax credits were properly disallowed under section 269(a).

SUMMARY OF FACTS

Introduction and Overview

A U.S. taxpayer who pays $1 of foreign tax and claims $1 of foreign tax credit pays the same amount of tax as if it had paid the $1 to the United States. A U.S. taxpayer who pays $1 of foreign tax, is reimbursed for 50 cents of it by a counterparty, but still claims $1 of U.S. foreign tax credit comes out ahead

by 50 cents. If the counterparty simultaneously recovers the $1 of foreign tax through the foreign tax system, uses 50 cents of that to reimburse the U.S. taxpayer, and keeps the other 50 cents, then both parties are now ahead, each by 50 cents. But the U.S. government has given $1 of foreign tax credit when no foreign tax was in fact paid. Blown up to size, this is STARS.

BNY was one of six U.S. banks to buy STARS (Structured Trust Advantaged Repackaged Securities), a foreign tax credit arbitrage transaction that was conceived and promoted by Barclays Bank plc ("Barclays") and the Washington National Tax Practice of KPMG LLP ("KPMG"). The economic purpose of STARS was to reduce BNY's and Barclays' tax liabilities in the U.S. and the U.K., respectively, by allowing each of them to claim tax credits for illusory U.K. tax costs.

STARS triggered the imposition of a nominal 22% U.K. income tax on BNY income diverted to a specially created trust (the "Trust" or "STARS Trust"). STARS exploited differences between the U.S. and U.K. tax laws so that both BNY and Barclays claimed tax credits for the 22% U.K. tax paid by the STARS Trust. Barclays' U.K. credit for the trust tax together with other STARS-related deductions allowed it to recover, though the U.K.

tax system, $18.70 of every $22 of U.K. tax paid by the Trust. Barclays paid part of what it referred to as its "U.K. tax benefit" to BNY, effectively reimbursing BNY for half the cost of the U.K. trust tax. BNY's sole benefit from STARS was U.S. foreign tax credits for the U.K. tax payments that were effectively reimbursed by Barclays.

Barclays called STARS a "double dip," explaining in marketing materials that "[t]he benefit under STARS arises from the ability of both parties to obtain credits for the taxes paid in the trust. Thus, the benefits to both [parties] . . . are easy to calculate and are equal to 50% of these taxes for each party."[1] The circulation of U.S. income through the Trust, the payment of U.K. tax by the Trust, the recovery of the U.K. tax through Barclays' U.K. tax return, and the reimbursement of half that tax to the U.S. party was the essential "building block" of the STARS transaction. This building block created a benefit or "free money" of $22 for every $100 of income subjected to tax, that was then split between the parties. Both parties would benefit from the structure by claiming tax credits for one payment of tax. For BNY, STARS generated credits for foreign

[1] BBPLC0001419.

tax that it did not economically bear.

Although the goal of STARS was simple -- create U.S. tax benefits for 50 cents on the dollar -- a complex web of specially-created entities and agreements were needed to generate tax savings for the parties without affecting BNY's economic interest in its income or assets. First, the deal had to subject income from BNY's assets to U.K. tax while preserving BNY's rights to control the assets and retain their economic benefit. Second, the deal required a mechanism for Barclays to deliver to BNY half of the U.K. tax cost paid by the STARS Trust.

The structural solution to the first requirement was for BNY to contribute U.S. assets that the bank owned (participations in mortgage loans, asset-backed securities, and agency securities) to another specially created BNY STARS entity (DelCo). DelCo would make agreed distributions of income to a Delaware trust that would be treated as an "unauthorized unit trust" for U.K. tax purposes. BNY subjected the income distributed to the Trust to U.K. tax by appointing a U.K. trustee. BNY retained its economic interest in the assets used in STARS and managed those assets from the United States. Barclays had a nominal interest

in the Trust that was recognized for U.K. tax purposes, but it did not have any economic or managerial interest in the underlying assets. Almost all of the income of the Trust was distributed to Barclays in circular cash flows from the Trust to a "blocked account" over which Barclays had no control, and back to the Trust. In this way, the U.K. tax paid by the Trust at a 22% rate could be claimed as a foreign tax credit in the U.S. by BNY, which took the position that it owned all of the interests in the Trust, and also as a credit in the U.K. by Barclays, which took the position for U.K. tax purposes that it owned an interest in the Trust that entitled it to 99% of the distributions of the Trust, all of which round-tripped back to BNY.

Different solutions to the second requirement -- the delivery system for Barclays' reimbursement of the U.S. bank for half of the tax -- were considered during the development of the transaction. The original concept of STARS used the unauthorized unit trust ("UUT") building block to create duplicate tax credits but used an "enhanced" investment transaction in which Barclays would share the U.K. tax cost by paying a fee to the U.S. bank in connection with a stock loan.

Barclays tried but failed to sell that version. By the time STARS was sold to BNY, Barclays was targeting the transaction to mid-tier U.S. banks. Instead of an investment structure, the trust building block had morphed onto a loan of $1.5 billion from Barclays to BNY that was over-collateralized by highly rated assets so that Barclays assumed negligible credit risk. Barclays' reimbursement of half of the U.K. tax nominally paid by the Trust was styled as a component of an interest rate on the loan (referred to as "the spread"). It was delivered to BNY via Zero Coupon Swap payments that subtracted the spread from the amount Barclays characterized as the real interest on the loan. The loan version of STARS would allow the U.S. taxpayer to claim to have entered into STARS to get "low-cost financing."

In fact, the spread had nothing to do with calculating interest on the $1.5 billion loan or with compensating Barclays for the use of its money. Indeed, the spread was not dependent in any way on the amount or tenor of the loan or BNY credit risk. The calculation of the spread is undisputed: it was half of the anticipated U.K. tax cost of the Trust. The spread was therefore, a function of the income subjected to U.K. tax.

The parties to the BNY STARS transaction knew from the outset that LIBOR[2], on which the real interest rate on the $1.5 billion was based, was so low that the tax reimbursement from Barclays to BNY would exceed the interest due from BNY to Barclays on the loan. And as expected, Barclays ended up paying BNY in most of the years of the transaction. BNY dealt with this anomalous result by calling the amounts it received from Barclays "negative interest."

Economic Evidence

The economic evidence, including expert testimony, will show that STARS generated and shared tax benefits for both participants and produced nothing else of value. BNY claimed $100 million a year in U.S. foreign tax credits from $455 million of annual income produced by its U.S. assets that was circulated through the Trust and subjected to a 22% U.K. tax. BNY effectively recovered half of its U.K. tax expense through the spread of $50 million per year transferred by Barclays. A "Stripping Transaction" added to STARS, in which the Trust sold interest rights to another BNY entity, produced another $88

[2] The London InterBank Offered Rate, or LIBOR, is the average interest rate at which large banks that participate in the London interbank money market can borrow unsecured funds from other banks.

million in foreign tax credits for U.K. tax, half of which BNY recovered through an additional $44 million in spread payments from Barclays.

The cash flow analyses presented by Respondent's economic experts are unrebutted. Both experts show that the only expected benefit from STARS is a reduction in U.S. tax payments that is only partially offset by an ultimately small payment of U.K. tax. Expert analysis reveals that while the Trust paid 22% U.K. tax on the Trust's income, after all the cash flows are taken into account, Barclays recovers nearly all of the cost of the Trust taxes -- on net the U.K. retained a tax of only 3.3%.

Barclays designed STARS so that it could claim a tax credit for the 22% Trust tax paid by its U.S. counterparty and also take a deduction that wiped out most of its reported income from the Trust. As a result, the trust structure alone allowed Barclays to recover $15.40 of every payment of $22 of U.K. tax by the Trust.[3] Barclays converted this "U.K. tax benefit" of $15.40 into a pretax equivalent amount of $22 and offered to

[3] Barclays remaining benefit was recovered by deducting the $11 spread payment ($15.4 + (30% x $11) = $18.70.

split the $22 with BNY through the spread payment.[4] Every $100 of income that BNY ran through the Trust, therefore, resulted in a tax credit of $22 that produced profit through the tax system of $11 for each of BNY and Barclays equal to the tax credit on the "free" part of the U.K. Trust tax. BNY's "free" Trust tax was paid to it by Barclays in the spread payment. Barclays was not out-of-pocket for the spread, however, because it received its cash through its U.K. tax return.

Although the source of the profits was entirely attributable to tax manipulation, both parties reported their profit as taxable income. Each government taxed its participant on the $11 of profit per $100 of Trust income. BNY's net after-tax profit was $7.15 ($11 - (11 x 35% U.S. corporate tax rate)) and Barclays' was $7.70 ($11 - (11 x 30% U.K. corporate tax rate)).[5]

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[4] Barclays was taxed at a corporate rate of 30%: $15.40 ÷ (1-.30) = $22.

[5] BNY's after-tax profit consisted of the excess of the U.S. foreign tax credits for the "free" half of the 22% of U.K. tax expense reimbursed by Barclays less the U.S. tax on the spread reimbursement, or 7.15% of the income from the Trust assets. Barclays' after-tax profit consisted of the excess of the U.K. credit for its "free" half of the 22% of U.K. tax expense paid by BNY less the U.K. tax on that half of the credit or 7.7% of the income from BNY's Trust assets.

Respondent's economic experts show that the only value produced by STARS is traced to and funded by the foreign tax credits from the U.S. Treasury. The foreign tax credits that BNY claimed in the U.S. at a 22% rate were far more than the actual U.K. tax attributable to STARS, which Barclays reduced to 3.3 through its own return.[6] In other words, BNY claimed credits for phantom U.K. tax expense. For every $100 of income circulated through the Trust, the U.S. government lost $18.15, which funded BNY's profit of $7.15, Barclays' profit of $7.70, and the U.K. tax of $3.30.[7] The tax saving financed by the foreign tax credit is the only profit realized by BNY from participating in STARS. The evidence will prove that no rational person would have participated in STARS if it did not generate U.S. foreign tax credits.

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[6] Barclays deducted the spread payment, but it did not share that tax benefit with BNY. The tax savings from the Trust structure of $15.40 plus the value of the deduction of the spread of $3.30 ($11 x 30% corporate rate) resulted in a U.K. tax benefit to Barclays of $18.70. The U.K., therefore, kept only $3.30 of the original $22 paid by the Trust.

[7] The net effect to the U.S. government was $3.85 minus $22 of foreign tax credits, or a loss of $18.15. The U.S. government received only $3.85 from STARS, which is the 35% tax on BNY's $11 of profit.

The economic evidence will show that the spread is not low-cost financing, as Petitioner's witnesses will contend at trial. Respondent's economic experts and bank treasury expert Mr. Cipullo will explain that the interest rate from which the spread was subtracted materially exceeded the rate at which BNY could have readily borrowed in the interbank market. Respondent's banking and structured finance experts, Dr. Saunders and Prof. Schwarcz, explain that a loan transacted between two large sophisticated banks at an interest rate of LIBOR minus 360 basis points ("bps.") makes no sense as a commercial transaction and would never happen. Negative interest is unheard of in the interbank lending market.

The only possible conclusion in light of banking industry practice, economics, and indeed common sense, is that the spread buried in the Zero Coupon Swap formula is not an interest payment but the sharing of a tax expense. The $50 million annual spread is Barclays' reimbursement to BNY of U.K. tax paid by the Trust, and is therefore not pre-tax income to BNY. Moreover, even if U.K. tax effects such as the spread are taken into account in measuring pre-tax profit or cost, Respondent's

experts will explain that all related tax effects must be considered in order to rationally measure the economic consequences of the transaction. Therefore, if the spread were included as pre-tax income, then consistency would require that the Trust's U.K. tax payments of $100 million annually that resulted in the spread must also be taken into account as pre-tax cost. Under either approach, the routing of BNY's cash flows through the Trust made no sense but for the U.S. foreign tax credits.

Rebuttal Expert Evidence

Since filing its Petition, BNY has changed its business purpose story. Its trial experts posit business purposes and non-tax benefits that BNY has not previously attributed to the STARS Transaction. In its Petition, BNY alleged that the benefit of STARS was low-cost financing generating an annual $54 million benefit and totaling $270 million over the life of the deal. Pet. ¶ 5.A.(6). BNY's trial expert, Dr. Atherton, however, opines that total expected profit from STARS was $1.6 billion during the five-year term, six times the benefit alleged

in the Petition. Dr. Atherton treats the "Target Income,"[8] which BNY was required to inject into the STARS Trust, as profit attributable to STARS. He also includes profit he assumes BNY would derive from using the $1.5 billion loan proceeds, attempting to link STARS to BNY's decision to modify its asset mix by buying asset-backed securities and making fewer loans. BNY's experts also allege new liquidity and interest rate management benefits from STARS.

None of these after-the-fact justifications withstands scrutiny. The Trust Target Income was generated by previously-owned BNY assets that belonged to BNY and would have generated income whether or not BNY engaged in STARS. The "projected income" from investment of the loan proceeds conflates two independent issues - the source of funds and their use - and, in any case, is undermined by the absence of any contemporaneous evidence.[9] The supposed liquidity and interest rate benefits are

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[8] Petitioner's expert Dr. Atherton uses the term "Target Income" to describe the annual Trust distributions BNY was economically compelled to make. Atherton Opening Report at 7, 38. This amount was approximately $460 million. The required distribution for the C Unit was approximately $455 million.

[9] Further, when Petitioner's expert Dr. Atherton leaves out the Trust Target Income and counts as profit only the income from the investment of the $1.5 billion loan proceeds, the

equally flimsy. STARS was a complex and very costly deal to execute but was terminable on five days' notice without cause, belying Petitioner's claim that STARS served any useful nontax purpose as a liquidity facility. Similarly, although BNY's experts contradict one another concerning the value of incorporating a floating interest rate in STARS, BNY could accomplish the management of interest rate risks more directly and at far less expense through conventional derivatives.

In sum, the record will establish that STARS was a pricey financing that no prudent banker would undertake but for the tax benefits generated by the meaningless circulation of cash flows through the Trust. The trial record will establish that the driving economic effect of STARS was the tax profit from claiming U.S. foreign tax credits for overstated U.K. tax costs, a profit achieved through the tax system that was split between Barclays and BNY at the expense of the U.S. fisc. The economic evidence will quantify this split and will show that the STARS Transaction makes no rational economic sense for BNY without the U.S. foreign tax credits generated by the transaction.

The STARS Participants

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transaction produces an economic loss to BNY as a result of its payment of the U.K. tax.

Bank of New York. KPMG tax partners brought the STARS Transaction to BNY's Tax Director John DeRosa in June 2001. KPMG's tax partners did not promote STARS to BNY because BNY needed funding. Rather, BNY managers were addicted to tax-driven transactions; having already entered more than 100 "LILOS" and "SILOS", foreign tax credit transactions provided another means of reducing tax on unrelated income. Internal BNY documents show that corporate tax shelter transactions were an important source of revenue for BNY.[10] BNY Treasurer Thomas Price touted STARS in Treasury's Strategic Plans: STARS was a "tax advantaged revenue strategy" and one of BNY's "FTC revenue trades."[11]

BNY's Management team, including CFO Bruce Van Saun and Accounting Officer John Park, approved BNY's participation in

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[10] In its internal financial reporting, Petitioner treated LIBOR + 30 bps. as its cost of the funds transferred by Barclays and separately treated the spread as its benefit from STARS, which was a revenue item.

[11] Ex. 327-J. Shortly after undertaking STARS, BNY purchased another foreign tax credit structure from Barclays called TOGA. In TOGA, high-grade debt securities were assumed by BNY subject to a total return swap agreement that effectively offset BNY's risks. BNY claimed foreign tax credits for U.K. taxes imposed on income from the securities and then disposed of the securities pursuant to a pre-arranged sale. BNY did two TOGA trades.

STARS. BNY's Strategic Solutions Group ("SSG"), headed by Gerald Colaluca, was the "deal team for tax advantaged transactions,"[12] and along with Mr. DeRosa, was responsible for the implementation of STARS.

Barclays Bank plc. Barclays' Structured Capital Markets Group ("SCM") was headed by Roger Jenkins and U.K. tax lawyer Iain Abrahams. Tax arbitrage transactions were an important part of SCM's business. Barclays understood that BNY was highly receptive to a wide range of tax-based ideas and had targeted BNY for an SCM "tax product" after discussions with BNY senior executives.[13]

Sohail Sultan and Alkis Ioannidis of SCM designed STARS in 1999 to manufacture tax credits for Barclays and a U.S. counter-party by circulating U.S. income through a U.K. resident trust. The transaction would be highly profitable for Barclays, and SCM focused on selling STARS to U.S. taxpayers. Barclays entered into six STARS transactions with U.S. banks that generated claims for approximately $3.4 billion in U.S. foreign tax credits.

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[12] Ex. 327-R.

[13] Ex. 344-R.

KPMG LLP. Kevin Glenn, David Brockway and David Schenck of KPMG sold STARS to BNY for a fee of $6 million. In 1999, Barclays' SCM had engaged KPMG Tax Partner David Brockway to write a U.S. tax opinion (a marketing opinion) for what Barclays dubbed "Project STARS." KPMG tax partners then promoted STARS to U.S. banks. KPMG also served as the U.S. banks' tax adviser and provided tax opinions. The first STARS transaction involved First Union National Bank ("First Union").[14] BNY STARS was the second STARS transaction.

Sidley Austin. R.J. Ruble, then of the Sidley Austin law firm, met with Barclays about STARS in the summer of 2001. Barclays recommended that BNY retain Mr. Ruble as BNY's adviser and to write a tax opinion blessing STARS. Mr. Ruble and other lawyers at Sidley Austin participated in aspects of the structuring of BNY's STARS transaction.

Development of the STARS Transaction

SCM designed the prototype STARS transaction in 1999. Barclays Capital approved STARS as a tax product in February

[14] First Union merged with Wachovia Bank in 2001. Wachovia Bank was acquired by Wells Fargo Bank in 2008.

2000. The transaction generated U.S. foreign tax credits by circulating income through a special purpose vehicle (a "collective investment scheme" for U.K. regulatory purposes and an "unauthorized unit trust" for U.K. tax purposes) that would be subject to U.K. tax and allow Barclays to return half the tax costs without reducing the amount of foreign tax credits claimed. To Barclays' approval committee, SCM explained the transaction as "allowing Barclays to own the [C] Units (and underlying credits) for U.K. purposes, and achieving the same result for USCo for US purposes."[15]

The prototype STARS was structured as an investment transaction for a U.S. taxpayer and used a fee and not a loan to the U.S. taxpayer as the means for Barclays to pay its U.S. counterparty. Barclays, however, found no buyers for that alternative. Thus, in its initial presentation to First Union, the first U.S. bank to purchase STARS, Barclays offered the transaction structured as either a loan or an investment; either alternative could be used as a method to deliver the tax rebate. First Union elected to use a loan and a loan was part of the STARS structure presented to BNY.

[15] Ex. 190-R.

The development of STARS confirms that the tax benefits produced by circulation of income through the STARS Trust are economically unrelated to the loan that was later added to the STARS building block. Barclays' approval documents focus on the duplicative benefit created by the payment of the trust tax. KPMG partner David Brockway explained that "[t]he benefit from the transaction is essentially independent of the amount of net borrowing from Barclays; it is a direct function of the amount of income run through the trust and subject to the 22% U.K. tax."[16] Respondent's expert Michael Cragg shows that, whether the loan that was added to STARS is $1 dollar or $1.5 billion, the amount of the benefit from the transaction is the same.

BNY's Decision to Buy STARS

BNY was pitched STARS in June 2001 when KPMG tax partner Kevin Glenn approached BNY Tax Director John DeRosa, offering BNY a "Trust Partnership Financing Technique" where "both banks claim tax credits for the same tax on income earned through a Delaware trust."[17] The tax benefits -- foreign tax credits for

[16] Ex. 363-R.
[17] Ex. 330-R.

the "free" half of the U.K. tax cost reimbursed by Barclays -- were derived in the same manner as in the original prototype transaction.

Anxious to secure what BNY's Treasurer called a "windfall," BNY found assets to transfer to the STARS Trust, which was "the only way to max out the benefits."[18] In an August 17, 2001 conference call, Barclays explained that the Trust would hold shares of stock in a lower-tier entity (the DelCo entity). This would give BNY greater flexibility in the assets it transferred and complete control of the income transferred to the trust, which would be in the form of dividends from DelCo. During that call, Barclays recommended that BNY engage Sidley Austin as tax counsel.

On August 21, 2001, Barclays provided a term sheet and simplified model of STARS showing $2.9 billion of assets in the Trust including a $1 billion loan, with a total benefit of $56 million that Barclays and BNY would split on a 50-50 basis. Barclays' reimbursement of the U.K. tax expense, the so-called

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[18] Price Depo. Transcript at 88; Ex. 361-R. On August 11, 2001, Barclays requested its Credit Committee to increase its credit risk limits given the "STARS" type transaction and tax business under discussions." Ex. 346-R.

U.K. benefit, would be delivered as a reduction in borrowing costs on a $1 billion loan. Dividing BNY's projected $28 million benefit by the $1 billion loan amount would result in a 311 bps. (3.11%) benefit that is portrayed by Petitioner and Barclays as a reduction in funding costs.

BNY was assured that it would continue to own and control the assets purportedly transferred into the Trust and it would expect no change in its management of the assets other than increased administrative costs. BNY understood that Barclays would have no economic interest in the Trust assets or any right to any income from the assets. BNY would agree to enter into separate security agreements that would grant Barclays a security interest in a portion of the assets transferred to the Trust and to Delco.

On August 23, 2001, BNY Tax Director John DeRosa advised KPMG that BNY was prepared to move forward by contributing $6 billion of assets to the Trust to produce a U.K. tax of $93 million per year and an expected benefit of $46.5 million for each of Barclays and BNY. BNY's REIT would be used to increase the projected income that would run through the STARS Trust, and, in turn, determine the amount of U.S. foreign tax credits.

At the time of the STARS transaction, BNY could readily borrow as much as it needed in the interbank lending market at an interest cost of LIBOR. Further, at the time BNY was considering STARS, it had substantial excess liquidity and was a net seller, i.e., lender, of funds in the interbank market. But BNY was eager to close the transaction so it could report the spread as net interest income in its third quarter 2001 financial statements.

The events of September 11, 2001, and Barclays' credit consideration of BNY delayed the closing until November 7 and 8, 2001. In the meantime, discussions with Barclays focused on how to minimize and share tax risk. One issue raised was how to account for the potential "negative interest" payments BNY would receive if LIBOR remained below 3%, which would not be unexpected.

What was not considered was any liquidity benefit or interest rate mitigation benefit that Petitioner now contends arise from STARS. Nor is there documentary evidence that BNY expected to use the loan proceeds to finance specific income-generating assets. And no document cites income from the assets

that BNY planned to move into the STARS structure as a benefit of or profit attributable to STARS. The focus of the participants was how to maximize the benefit from the tax credits, ultimately $100 million annually, and to add the Stripping Transaction to accelerate the benefits.

The Trust purportedly ended up with the income produced by 10% of BNY's total assets of $80 billion. Despite its size, there was no formal corporate management consideration of STARS, no documents approving STARS generally or specifically the transfer of BNY assets to the Trust structure, no mention of STARS in the BNY Asset and Liability Committee minutes, and no mention of STARS in BNY's financial statements or Form 10-Ks. BNY auditor E&Y can find no workpapers or other documents pertaining to STARS. BNY never discussed STARS with its state or federal regulators; it simply notified them a day before closing that the transaction would take place. This evidence shows that the transfers to the Trust and the circulation of income and assets from one pocket of BNY to several newly created pockets were not meaningful changes from a business or economic perspective.

BNY's Accounting Treatment

BNY claims to have accounted for STARS in its financial statements consistent with its substance (and not its form), treating STARS as a secured financing. Specifically, Barclays' $1.5 billion loan, which, as explained below, was structured as the purchase of C and D Units in the Trust, was reflected as a deposit in InvestCo's books and records and consolidated financial statements of BNY. This $1.5 billion liability was booked in BNY's Cayman branch. The assets used in the Trust structure continued to be reported as part of the consolidated balance sheet of BNY and the income the assets generated continued to be reported as part of BNY's income statement. As part of its substance-based recast of STARS, BNY recharacterized the periodic net payments under the Zero Coupon Swap (interest expense on the loan minus the spread) as interest expense. By reducing its reported interest expense by the amount of the spread payments, BNY increased its reported net interest income, and, as noted above, was eager to show an additional $50 million of annual income.

STARS Set Up

In order to participate in the STARS Transaction, BNY was required to create new BNY corporate and partnership entities and a Delaware trust and transfer BNY assets to these entities. On November 7, 2001, before the STARS transaction closing date, BNY followed six steps to set up the necessary structure to implement STARS.

1. BNY transferred $3.91 billion in net assets (mortgage loans, asset-backed securities and agency securities), comprised of $6.46 billion in assets subject to $2.55 billion in liabilities to BNY REIT Holdings ("REIT Holdings"), a wholly owned and preexisting BNY entity. At the time, REIT Holdings already owned shares in BNY Real Estate Holdings LLC ("REIT Shares").

2. REIT Holdings formed BNY Investment Holdings, LLC ("InvestCo"), a Delaware limited liability company. REIT Holdings contributed REIT Shares, valued at $3.95 billion, plus the net $3.91 billion of assets it had received from BNY, a total of $7.86 billion in net assets (the "Net BNY Assets"), to

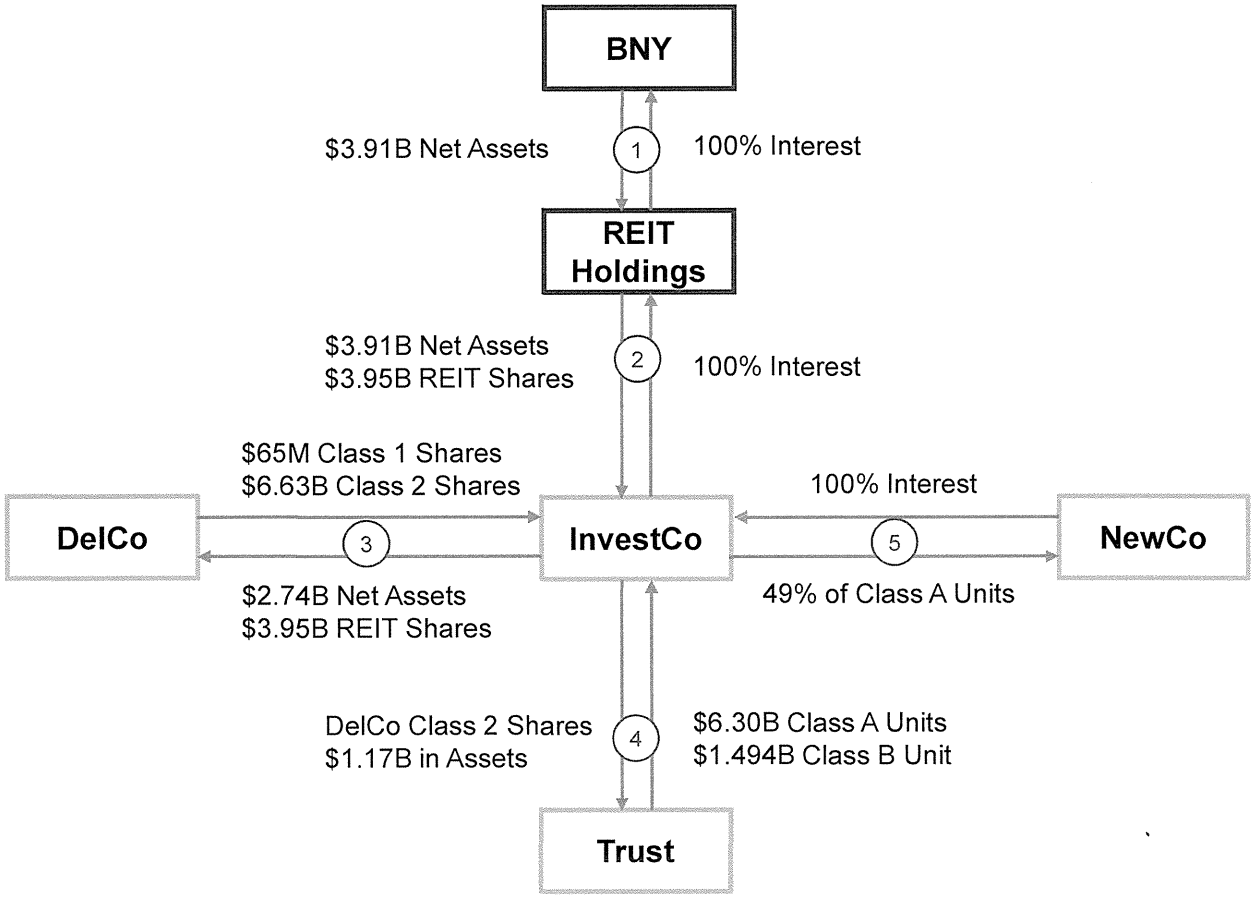
InvestCo in exchange for a 100% ownership interest. InvestCo elected to be treated as a corporation for U.S. Federal income tax purposes.

3. InvestCo capitalized BNY Delaware Funding LLC ("DelCo"), another newly created Delaware LLC, with all but $1.17 billion of the Net BNY Assets it had received from REIT Holdings. Thus, DelCo held assets and liabilities with a net value of $6.69 billion (the "DelCo Assets"). In exchange, InvestCo received all the DelCo Class 1 and 2 Shares. All the asset control and voting power resided with the DelCo Class 1 Shares, while the DelCo Class 2 Shares were to receive virtually all (99%) of the income.

4. InvestCo contributed its remaining $1.17 billion in assets (the "Trust Assets") along with all the DelCo Class 2 Shares, with a stated value of $6.63 billion, to the Trust, a newly created Delaware entity. In exchange, InvestCo received Trust Class A and B Units, which had a stated value of $6.30 billion and $1.494 billion, respectively. The contribution of the Class 2 shares to the Trust created a second interest holder in Delco, which then elected to be treated as a partnership for

U.S. Federal income tax purposes.

5. InvestCo contributed 49% of the Trust Class A Units to a newly created BNY entity, BNY NewCo Funding (DE), LLC ("NewCo"), in exchange for 100% ownership interest in NewCo. The following diagram illustrates these steps.



6. InvestCo distributed 1% of its interest in NewCo to REIT Holdings. NewCo elected to be treated as a partnership for U.S. Federal income tax purposes.

STARS Loan

The STARS Loan did not look like a financing. Instead, the terms of the loan were scattered among three agreements:

1. *Trust Class C Unit and Class D Unit Subscription Agreements*. Barclays purchased from the Trust the Class C Unit for $1.469 billion and the Class D Unit for $25 million, a total of $1.494 billion.

2. *Trust Class C and D Unit Forward Sale Agreements*. Barclays agreed to sell the Trust Class C and D Units to InvestCo on November 20, 2006, or earlier in the event of default or acceleration (the "Maturity Date"), each for a predetermined price. The C Unit forward sale price was equal to the principal amount of $1.475 billion plus an interest rate computation equal to interest compounded annually at 4.338% less a fixed amount based on the amount of U.K. taxes paid by the Trust. This interest rate computation was offset by an identical obligation of Barclays in the Zero Coupon Swap. The D Unit forward sale price was the same as the original

subscription price, $25 million. Under the Forward Sale Agreements, therefore, Investco was obligated to repay Barclays the principal on the Loan of $1.5 billion.

3. *Zero Coupon Swap.* InvestCo and Barclays entered into a swap whereby Investco agreed to make monthly payments to Barclays in return for a fixed payment from Barclays on the Maturity Date.[19] The monthly payments made by InvestCo were equal to the 1-month LIBOR plus 30 bps. on a notional amount of $1.475 billion, which over-compensated Barclays for the use of funds, less the Floating Rate Spread Amount (the spread), which represented Barclays' reimbursement of half the anticipated U.K. tax cost of the Trust and which, despite its name, was fixed and predetermined.[20] The fixed leg payment of the Zero Coupon Swap by Barclays on the Maturity Date was calculated by formula, such that it would equal and offset the interest rate computation in the Forward Sale Agreement, that is, any amount of the C Unit forward sale price in excess of $1.475 billion.

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[19] As discussed above, the parties anticipated that the spread would exceed the LIBOR based interest rate and that Barclays would make net payments to BNY.

[20] BNY's half of the trust tax (called "bx" in the swap agreement) was reduced by a time value of money factor to account for the fact that the spread would be paid before Barclays received its credit.

Once Barclays subscribed to the C and D Units, the Trust redeemed the Class B Unit from InvestCo and transferred $1.494 billion to an account of InvestCo. In combination these steps had the effect of a loan from Barclays to BNY for $1.5 billion.[21] BNY would pay the interest on this loan through the Trust distributions on the D Units and the monthly LIBOR-based amounts under the Zero Coupon Swap, excluding the Spread.[22] BNY would repay the principal through the Forward Sale prices, net of the fixed leg of the Zero Coupon Swap.

Barclays had the right to accelerate the C and D Unit Forward Sale Agreements within thirty days without cause by giving five days' notice and paying a small breakage fee of $3-4 million (representing part of KPMG's fee) that gradually decreased over time. BNY had the right to accelerate each Forward Sale Agreement at any time without a breakage fee.

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[21] As noted above, KPMG was paid $6 million for the BNY STARS Transaction. This fee was paid by Barclays but economically borne by BNY. This is reflected in the difference of $6 million between the total cash paid by Barclays for the Class C and D Units, $1.494 billion, and the principal of the Loan, $1.5 billion, which was due on the Maturity Date as the Class C and D Forward Sale Prices. In essence, Barclays recovered its payment from BNY by issuing its $1.5 billion loan at a discount.

[22] Interest on part of the loan, the $25 million from the D Unit Subscription, was repaid through the Class D Unit Distributions.

Credit Risk

Barclays' Group Credit Committee required that BNY's loan be secure. Security agreements were signed at closing under which BNY assets designated as "Collateral Eligible Assets" were subject to a perfected first priority security interest in favor of Barclays. The aggregate market value of the Collateral Eligible Assets was required to be at least $2.25 billion and had to meet strict criteria with respect to credit ratings: at least $1.5 billion had to be AAA-rated; at least 80 percent had to be AA-rated, only 5% could be BBB-rated and at least 80 percent had to be denominated in U.S. dollars.

BNY was obligated to ensure that the quality and total value of the securities met these requirements, and was required to provide information about the amount and quality of the securities to Barclays on a monthly basis. But otherwise, and as John DeRosa told CEO Tom Renyi, "BNY Treasury will retain full control over collateral within pre-agreed parameters,"[23] retaining the power to substitute, dispose of, and manage the

[23] Ex. 446-J.

securities. Only in case of InvestCo's default on its obligations under the loan would Barclays gain control over the Collateral Eligible Securities.

As additional security for the loan, BNY entered into a Credit Default Swap Agreement ("CDS") with Barclays by which BNY guaranteed all obligations of InvestCo, in case of InvestCo's bankruptcy or default. Barclays paid BNY 10 basis points on the notional amount of $1.475 billion annually for the CDS.[24]

Barclays' credit risk was negligible. Its credit committees carefully evaluated Barclays' credit risk. The Group Credit Committee's model calculated Barclays' return on economic capital as 1000 percent, suggesting nearly no risk. The $1.5 billion was over-collateralized with $2.25 billion of assets comprised primarily of high quality, liquid securities. In addition, the CDS granted Barclays recourse to BNY, meaning that even if the Collateral Eligible Assets were severely impaired, only a concurrent collapse of BNY could have put any of Barclays' principal amount at risk.

[24] When Barclays' 10 bps. CDS payments are netted against the LIBOR plus 30 bps. rate in the Zero Coupon Swap, the net cost to BNY is LIBOR plus 20 bps., excluding the spread.

Circulation of BNY Income through the Trust Structure

The heart of the STARS transaction was the Trust structure that triggered the U.K. tax liability for which both BNY and Barclays could claim tax credits. Pursuant to the complex series of transaction terms, BNY transferred a pre-arranged amount of income, i.e., Target Income, to the Trust based on the desired amount of tax benefits fixed prior to closing. A description of the specific transaction documents that effected the U.K. taxation and circular flow of BNY income follows.

On the Closing Date, BNY and Barclays signed the Trustee Replacement Side Agreement under which BNY agreed to replace its London branch as Trustee with a replacement company "which is resident in the U.K. for U.K. tax purposes."[25] This was subsequently done on November 14, 2001. This step was required to make the Trust income subject to U.K. tax. Once the income in the Trust was taxed in the U.K., BNY took the position that the income was resourced as foreign source income under Article 24(2) of the U.S.-U.K. Tax Treaty, although no Trust activities

[25] Ex. 49-J.

took place in the U.K. This was necessary to allow BNY to offset its U.S. tax on the claimed foreign source Trust income by the claimed foreign tax credits from STARS.

The Trust income consisted almost entirely of dividend distributions from DelCo. DelCo distributed dividends monthly, 1% to InvestCo as the owner of the Class 1 Ordinary Shares, and 99% to the Trust as the owner of the Class 2 Ordinary Shares (annual income of the Trust constituted approximately $460 million, $455 million of which was attributed to the C Unit distribution). BNY, as controlling shareholder of Delco, determined the amount of the DelCo distributions to the Trust, which were exactly the amount needed to meet the Target Income.

The Trust set aside 22% of its distributable income in Sterling-denominated assets to reserve for U.K. tax (approximately $100 million of U.K. tax annually at 22% of $460 million). The Trust distributed 1% of its net income ($3.5 million) to A Unit holders (InvestCo and NewCo), then 78% of LIBOR + 4.15% on $25 million to Barclays as the D Unit holder, and the remaining distributable income of the Trust (more than 98% of the overall distributable income) to Barclays as C Unit holder directly into Barclays' blocked account. Such net

distribution to Barclays on the C Unit amounted to approximately $350 million annually.

The $350 million distribution to Barclays' blocked account at BNY Bank was immediately re-invested in the Trust. The Class C Unit Subscription Agreement obligated Barclays to recontribute to the Trust any amounts received on the C Unit. The Trust then contributed the amounts to DelCo completing the circular flow of money. Barclays never had control or use of the amounts distributed by the Trust on the C Unit. The only distributions that were payable to and retained by Barclays were the distributions on D Units, which constituted less than 0.5% of the Trust's income.[26]

Under the Zero Coupon Swap, Barclays was obligated to pay BNY a fixed, predetermined spread amount that was equal to 50% of the anticipated amount of U.K. tax paid by the Trust on Target Income. In the swap agreement, the spread amount was subtracted from BNY's obligation to pay Barclays LIBOR + 30 bps. on the loan.

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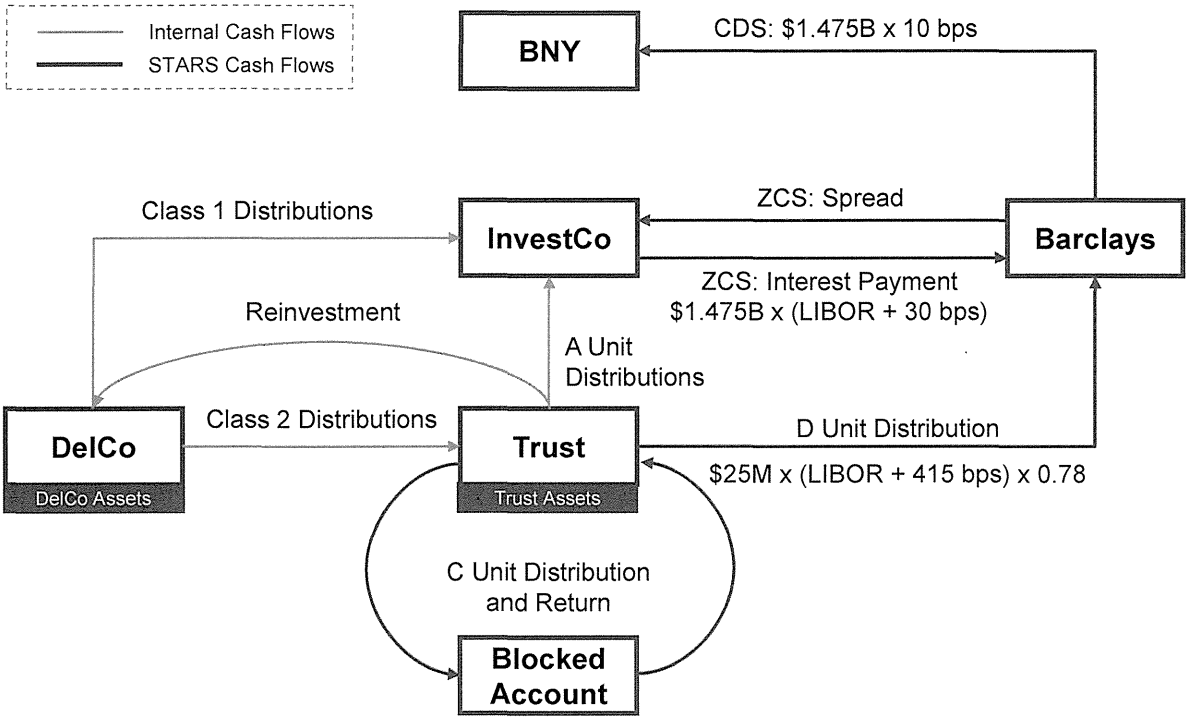
[26] During Barclays' development of STARS, the D Unit was added to the structure after a U.K. Queen's Counsel opined that the Trust's status under U.K. law could be questioned given Barclays' lack of economic interest in the Trust.

The monthly cash flows produced by the STARS structure are as follows:



Target Income

BNY and Barclays agreed at the outset that STARS would generate a preset $100,000,000 per year of tax benefits and "the spread amount" payable by Barclays under the Zero Coupon Swap was set at half that amount. To generate these tax benefits, BNY had to inject income of $460 million into the Trust. Barclays insisted on an indemnity from BNY in the event that the Trust had less income and, as a result, reduced tax benefits.

Specifically, Barclays effectively required BNY to guarantee that the Trust would generate not less than $460 million of annual income (the Target Income) to ensure that Barclays was not overpaying the spread and receiving a lesser benefit than it expected. If there were a shortfall between the target Class C Unit Distributions and the actual distributions made, InvestCo was obligated to make an indemnity payment to Barclays on the Maturity Date. The indemnity payment created an economic compulsion for BNY to meet the monthly target Class C Unit Distributions. If InvestCo had to pay an indemnity amount to Barclays equal to a 22 percent Trust tax on the distribution shortfall, the indemnity payment itself would not be a U.K. tax that would be creditable. InvestCo would effectively pay the Trust tax with neither a reimbursement by Barclays nor a foreign tax credit, creating an economic loss for the full amount of the indemnity payment.

BNY entered into currency hedges for U.K. tax purposes (with no actual cash flows) with the Trust. The hedges were put in place to eliminate any potential capital gains/losses of the Trust on any foreign exchange fluctuations that would have been taxable in the U.K. Capital gain taxes paid by the Trust were

not creditable to Barclays under U.K. tax law and thus did not give rise to a duplicative benefit.

The Stripping Transaction

The "Stripping Transaction" was a series of intercompany transfers that BNY undertook a month after STARS closed in November 2001. It increased the recognition of income by the Trust in the U.K. and the Trust's payment of U.K. tax. By design, its tax effect was to generate foreign tax credits that could be used against BNY's U.S. tax on unrelated foreign source income.

As pre-arranged, BNY contributed $402 million to DelCo, which bought from the BNY STARS Trust $402 million of interest coupons stripped from securities owned by the Trust. This maneuver added $402 million in income to the Trust that was taxable in the U.K., generating additional U.K. tax liabilities and additional U.S. foreign tax credits of $88 million in 2001, but no additional U.S. taxable income.[27] Barclays also claimed

[27] The Stripping Transaction exploited the inconsistency in bond stripping rules under U.S. and U.K. tax law. For U.S. tax purposes, when the interest coupons are stripped from the principal, the basis of the securities is allocated between the coupon and the principal proportionately to their fair market value under I.R.C. § 1286. For U.K. tax purposes, the allocation of the basis is not required, and therefore, the

U.K. credits for the additional U.K. tax paid on the coupon sale and paid BNY, via the Zero Coupon Swap, an additional spread amount (called "fx") equal to half of the U.K. tax paid by the Trust on the stripped income. The Stripping Transaction allowed BNY to claim foreign tax credits for additional U.K. tax. Most of the foreign tax credits claimed in 2001 ($88 million)[28] were generated by the Stripping Transaction.

BNY Management of STARS Assets

The evidence will show that there was no substantive change in BNY's economic ownership or management of the assets committed to the trust structure, or in BNY's right to the cash

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total amount of the sale proceeds received on the sale of the coupons would constitute taxable income. Thus, the Stripping Transaction produced additional taxable income of the Trust for U.K. tax purposes only, while for U.S. tax purposes there was no additional taxable income. To the extent that some of the income from the stripped securities would not be recognized in the U.S. until after the termination of the STARS Transaction, the Stripping Transaction affected not only the timing of the recognition of that interest income but also increased the total amount of income that was run through the Trust.

[28] As explained above, BNY treated the spread received from Barclays as reducing interest expense, and thus increasing net interest income in its financial reporting. BNY and Barclays agreed to recognize the benefits of the Stripping Transaction over a thirteen month period instead of simply adding $44 million to 4th quarter 2001 reported earnings. According to internal management reports STARS generated $80 million of revenue in 2002. Ex. 327-J.

flows generated by those assets. BNY enjoyed unrestricted control over such assets both before and after STARS. The Trustees (the initial trustee and the replacement U.K. resident trustee) and the Trust Manager ("The Bank of New York (DE)") were BNY entities. Only BNY had the right to appoint and remove the Trustee or the Manager. The Trust Manager entered into a Servicing Agreement with BNY giving BNY total discretion over the investment, withdrawal, and disposition of the assets.

Although BNY claims that the income from the assets should be subject to U.K. tax, the locus of the assets and their management remained in the U.S. by virtue of the Servicing Agreement. The same employees and departments at BNY continued their activities with respect to the assets and income in the Trust. The assets were transferred by BNY to the Trust only by book entry and continued to be managed and serviced by BNY employees in New York. All books and records relating to the assets were located in BNY offices in New York, and all administrative, clerical and accounting services relating to the assets were also performed by BNY employees in New York.

Neither DelCo nor the Trust ever had their own employees or physical offices.[29]

Operation of STARS

To achieve the tax benefits produced by the STARS form, BNY had to segregate and house some of its previously-owned assets in newly-created entities. While this complex arrangement had no commercial or economic effect on BNY's right to manage the assets or obtain the income they produced, it did result in substantial post-closing operational difficulties and expense. Furthermore, the continued decline of LIBOR, when coupled with the fixed, predetermined spread amounts, produced anomalous results.

The evidence will show that BNY's operation of the STARS transaction was plagued with accounting and bookkeeping errors. Internal BNY audits revealed that assets and income moving in and out of the STARS structure were not tracked. Internal auditors recommended increased oversight over STARS and SSG's tax transactions. BNY encountered operational difficulties in

[29] In 2003, BNY did make office signs, including a sign for the Trust, to be posted on a wall in Delaware, seeking to ensure that the newly established entities avoided New York state income tax.

valuing and maintaining required collateral and in managing and accounting for stripped securities. These errors and lack of attention to the operational details show that the inter-company paper shuffling and book entries were economically meaningless and expensive to administer. Indeed, aside from the Collateral Eligible Assets required as security by Barclays, BNY itself cannot identify the specific assets allegedly transferred to the Trust structure; there is only a general description of "participation interests" allegedly identified in a list at Freshfields, Bruchaus and Deringer (Barclays' attorneys) that BNY does not have. In STARS, the assets allegedly transferred to the Trust structure are of no matter. The only operational issue that mattered to BNY was making sure that the agreed amount of Target Income ended up in the Trust so that InvestCo could avoid an indemnity payment that would create an economic loss without any tax advantage.

Trust Income Shortfalls. DelCo's assets did not produce the agreed amounts of Target Income, forcing BNY to contribute additional assets to DelCo as the transaction progressed.[30] BNY

[30] KPMG structured a transaction called "Othello" for BNY in order to address this problem and increase the income of the Trust by contributing additional assets to DelCo, which also

also made up for Trust income shortfalls by distributing repayments of principal on loans that had been contributed to DelCo. BNY routed an estimated $378 million in principal payments through the STARS Trust during its 5-year term, which created U.K. income to the Trust but no U.S. income. The principal payments resulted in $83 million in U.K. tax, generated foreign tax credits of $83 million, and earned a spread of $41.5 million.[31]

"Negative Interest." LIBOR dropped below 3% by the time STARS closed and stayed below 3% until 2005. During that period, the spread due from Barclays under the Zero Coupon Swap was larger than the LIBOR plus 30 bps. interest payment due from BNY as shown in the table below. During the STARS negotiations, the parties had characterized such a net payment from Barclays as "negative interest" on the STARS loan.

Year	L + 30 bps.	Spread Amount	Amount Payable by Barclays
2001	$ 4,030,234	($ 16,367,970)	$12,337,756
2002	$ 31,473,794	($ 82,443,944)	$50,970,150
5 Year Total	$210,150,829	($291,822,698)	$82,648,314

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served to minimize state and local tax liabilities of the REIT held by DelCo.

[31] There would be no future increase in BNY's U.S. tax base that would be associated with the foreign tax credits.

Wind-Up of the STARS Transaction

BNY planned to extend STARS beyond the initial five-year term and, in 2006, executed an agreement with Barclays extending STARS for five more years. BNY abandoned this plan and STARS ended when, pursuant to the Forward Sale Agreements, InvestCo repurchased the C and D Units from Barclays on November 20 and December 20, 2006.

After the STARS unwind was completed, there was no reason to continue to subject the Trust to taxation in the U.K. or to resource its income under the U.K.-U.S. treaty. BNY replaced the U.K. Trustee of the Trust with the U.S. Trustee, thereby ending U.K. taxation of the Trust income and any claim that the Trust income is recharacterized as foreign source income under the U.S.-U.K. Treaty.

Barclays' U.K. Tax Reporting

BNY and Barclays negotiated the allocation of STARS tax risks. Barclays took on tax risk associated with the treatment of STARS in the U.K., other than the risk that the Trust would not be treated as an UUT for U.K. tax purposes. BNY assumed that risk in addition to all the U.S. tax risk. Barclays attained its benefit from crediting U.K. taxes that BNY paid

and, as a result of its negotiated tax risk agreements with BNY, has no direct financial interest in the U.S. tax litigation.

There is no dispute among the U.K. law experts that the STARS Trust met the technical requirements of U.K. law to be classified as a collective investment scheme for regulatory purposes and taxed as an UUT. Barclays' structuring focused on that point. As a UUT, the STARS Trust was liable for a U.K. income tax of 22% on the income from the BNY Assets put in the Trust as the tax planners intended.

The parties' U.K. law experts also agree on Barclays' U.K. tax reporting. A combination of deal terms meant that Barclays had no economic interest in the Trust income attributable to the C Unit. Despite the fact that distributions with respect to the C Unit were made to the blocked account and were immediately reinvested in the Trust, the sale price of the C Unit under the Forward Sale Agreement did not increase. Under U.K. law, however, Barclays' nominal ownership of the C Unit meant that it included in income the distribution, grossed up for the tax paid by the Trust at 22 percent, and could claim a credit for the tax paid by the Trust. Barclays was also able to reduce its U.K. tax base by deducting the reinvested distributions and the

spread payments under the Zero Coupon Swap. According to Barclays, STARS was taxable in the U.K. as a financing transaction and its taxable income was only the "interest receivable/interest income included in its financial statements in respect of the STARS transaction."[32] Barclays represented to HMRC that its profit was half of the tax paid by the Trust, that is, the part of the Trust tax borne by BNY.[33]

Petitioner's U.K. expert claims that while there was no issue with respect to the UUT reporting, HMRC might have advanced an argument denying the U.K. tax benefits to Barclays.[34] This is irrelevant speculation. Barclays convinced HMRC to respect its tax position, eliminating any perceived risk of challenge by the U.K. The transaction was tax additive to the U.K. because the U.K. collected more taxes with STARS than without STARS. Barclays justified its tax position on the ground that STARS amounted to a loan on which it earned a profit equal to half the Trust taxes and that Barclays would pay an

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[32] BNY004007-12.

[33] Ex. 170-R.

[34] Barclays was also concerned about the tax risk related to its deduction for its recontributions from the blocked account back to the Trust on the C Unit.

effective tax rate of 3.3% of Trust income.[35] HMRC documentation confirms that the U.K. accepted Barclays' characterization.

BNY's U.S. Tax Reporting

BNY applied the "substance over form" doctrine to STARS and recharacterized the amalgam of Barclays' investment in the Trust Units, BNY's obligation to purchase the Units in five years, BNY's obligation to make distributions on the D Unit, and the Zero Coupon Swap payments, as a $1.5 billion secured financing.

BNY's U.S. tax reporting and litigation position is premised on the fact that Barclays did *not* acquire an ownership interest in the Trust for U.S. tax purposes, and disregards Barclays' nominal purchase and holding of C and D Units in the Trust. It is undisputed that Barclays has no meaningful interest in the Trust.

Consistent with BNY's position that it owned all of the interests in the Trust for U.S. tax purposes throughout the transaction, InvestCo and NewCo reported 100% of the income of the Trust (income generated by the U.S. assets transferred to the Trust by BNY). When the U.K. Trustee was substituted for the U.S. Trustee, the income of the Trust became subject to U.K.

[35] (Half of 22% U.K. Trust tax) x (30% U.K. corporate rate) = 11% x 30% = 3.3%.

tax at 22%. BNY asserted that the resourcing rule under Article 24(2) of the U.S.-U.K. Tax Treaty applied to recharacterize U.S. source income from the assets in the Trust as foreign source income.

BNY treated the Trust as the person on whom foreign law imposed legal liability for the payment of the U.K. income tax for purposes of I.R.C. § 901. Based on the claimed status of the Trust as a partnership for U.S. tax purposes, the Taxpayer asserted that its consolidated subsidiaries InvestCo and REIT Holdings were entitled to claim a credit under section 901 for their distributive shares of U.K. tax paid or accrued by the Trust. Their respective distributive shares of the Trust income were allocated to foreign source income. BNY claimed foreign tax credits of $98 million and $101 million for U.K. tax paid on behalf of the Trust with respect to taxable years 2001 and 2002. Over the term of the transaction, BNY claimed foreign tax credits of close to $600 million.

BNY treated the net payments it received from Barclays under the Zero Coupon Swap as "negative interest" and used them to reduce other unrelated deductible interest expense. When the net swap payments are disaggregated into their separate

components, it is apparent that Petitioner in effect deducted as interest expense amounts equal to LIBOR + 30 bps. and included the amount of the spread in taxable income.

RESPONDENT'S LEGAL POSITION

I. The Foreign Tax Credits Generated by the STARS Trust Structure Were Properly Disallowed.

Courts apply the economic substance and substance over form doctrines to identify and disregard transactions undertaken solely for tax purposes. Frank Lyon Co. v. United States, 435 U.S. 561 (1978); Knetsch v. United States, 364 U.S. 361, 366 (1960); Goldstein v. Commissioner, 364 F.2d 734, 740 (2d Cir. 1966)(disallowing interest deductions where loan arrangements did not "have purpose, substance, or utility apart from their anticipated tax consequences"). The tax consequences of a transaction "are determined based on the underlying substance of the transaction rather than its legal form." Wells Fargo & Co. v. United States, 641 F.3d 1319, 1325 (Fed. Cir. 2011)(citing Griffiths v. Helvering, 308 U.S. 355, 357 (1939)). Economic substance and business purpose are required to ensure that a taxpayer's activities are "the thing which the statute intended." Gregory v. Helvering, 293 U.S. 465, 469 (1935). The Second Circuit Court of Appeals, to which this case is

appealable, has endorsed the Tax Court's application of a "flexible" analysis that considers whether a reasonably astute business person would have entered into the challenged transaction apart from tax benefits. See Gilman v. Commissioner, 933 F.2d 143, 146-48 (2d Cir. 1999), aff'g T.C. Memo. 1989-684; Lee v. Commissioner, 155 F.3d 584, 586 (2d Cir. 1998)(quoting Goldstein, 364 F.2d at 740), aff'g T.C. Memo. 1997-172; Winn-Dixie Stores, Inc. v. Commissioner, 113 T.C. 254, 279 (1999), aff'd, 254 F.3d 1313 (11th Cir. 2001).

BNY paid KPMG $6 million for an elaborate transaction, built around the STARS Trust, which would allow it to claim foreign tax credits for illusory U.K. tax expenses. BNY funded the STARS Trust with cash flows from U.S. assets. The transaction was profitable only to the extent that BNY could claim U.S. foreign tax credits for U.K. tax payments that were effectively reimbursed by Barclays.[36] Creating economic profit from duplicative tax credits was the sole purpose of the Trust

[36] "[G]rossing up and crediting a foreign tax that someone else bears is like printing money in the cellar ... ." John P. Steines, Jr., International Aspects of U.S. Income Taxation 339 (4th ed. 2009). While made in discussing technical limitations on the credit, Prof. Steines' observation is equally, if not more applicable here, where the printing of cash requires no foreign activities and neither of the parties bears the cost of the taxes at issue.

structure and explains why BNY agreed to pay an above-market price for the financing that was stuck onto the deal.

The Trust structure at the heart of STARS amounted to no more than two circular sets of transfers: the routing of BNY's income through the STARS Trust and the Barclays blocked account and ultimately back to BNY, and the payment of U.K. tax by the Trust so that Barclays could receive a tax credit and reimburse BNY for half the U.K. taxes. These transfers had no nontax effect on BNY's business, save for added costs. The Trust structure, and the transaction as a whole, lacked economic substance and business purpose.

STARS is not a transaction that the foreign tax credit statute was intended to cover. Congress enacted the foreign tax credit to alleviate double taxation arising from foreign business operations. See United States v. Goodyear Tire and Rubber Co., 493 U.S. 132, 139 (1989); Am. Chicle Co. v. United States, 316 U.S. 450, 451 (1942); Burnet v. Chicago Portrait Co., 285 U.S. 1, 7 (1932). Congress did not intend for the foreign tax credit (or related provisions under the U.S.-U.K. tax treaty) to be used as a cash machine that reduces unrelated tax liabilities. Where a taxpayer engages in no substantive

foreign activity and the putative foreign tax cost is generated by one set of circular transfers and is all but eliminated by a second set of circular flows, the legislative purpose is plainly subverted. See Pritired 1, LLC v. United States, 2011 WL 4552469 at *42 (S.D. Iowa Sept. 30, 2011)(explaining that the purpose of the foreign tax credit is to "*prevent* double taxation, not to generate an enhanced return on the basis of structuring transactions to increase the available FTCs." (emphasis in original)). Accordingly, the foreign tax credits in issue were properly disallowed under the economic substance and substance over form doctrines.[37]

[37] Courts often apply multiple judicial doctrines to structured tax transactions. See, e.g., Santa Monica Pictures v. Commissioner, T.C. Memo. 2005-104 (tax-motivated steps or entities disregarded under both the economic substance and substance over form doctrines); Andantech LLC v. Commissioner, T.C. Memo. 2002-97 (same), aff'd in part and remanded, 331 F.3d 972 (D.C. Cir. 2003); Schering-Plough Corp. v. United States, 651 F.Supp.2d 219 (D.N.J. 2009) (same), aff'd sub nom. Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011); Long Term Capital Holdings v. United States, 330 F.Supp.2d 122 (same)(D. Conn. 2004)(same), aff'd, 150 Fed. Appx. 40 (2d Cir. 2005); Altria Group, Inc. v. United States, 694 F.Supp.2d 259 (S.D.N.Y. 2010)(same), aff'd, 658 F.2d 276 (2d Cir. 2011); Pritired, 2011 WL 4552469 (applying substance over form, economic substance and other anti-abuse rules to a foreign tax credit transaction).

A. The Trust Structure Lacked Economic Effect and Must Be Disregarded.

BNY characterizes its recovery of half of the Trust's U.K. taxes through the Zero Coupon Swap as a reduction in the interest cost of the loan that was used to shroud the Trust tax play of STARS. The central issue before the Court is whether BNY can transform a tax deal into a business transaction through a loan that is not only unrelated commercially to the Trust, but uneconomic without the tax juice in the deal.

The operation of the BNY STARS Trust and the resulting cash flows are largely undisputed. Every month, BNY transferred the agreed amount of income from U.S. assets housed in DelCo into the Trust. Every month 22% of Trust income was set aside to pay U.K. income tax and virtually all of the remaining 78% was distributed to, and immediately recontributed by, Barclays. Every month BNY supplied a tax voucher to Barclays that entitled Barclays to offset other U.K. liabilities by the full amount of

the Trust tax, and every month Barclays transferred an amount equal to half the Trust tax to BNY in a swap payment (the spread).[38]

Unrebutted expert testimony analyzes the cash flows that STARS produced for the parties and their respective tax authorities. For every $100 of income routed through the Trust, Barclays gains $7.70 and BNY gains $7.15.[39] The U.K. tax authority collects only $3.30, while the U.S. Treasury loses $18.15. The record will show that these tax effects and the manner in which they were split between the parties were the only substantive effects of STARS. BNY's rights to the assets and income attributed to the Trust structure were otherwise unaffected.

The law is clear that tax benefits produced by circular transfers and tax collusion are "not the thing which the statute intended." See, e.g., Wells Fargo, 641 F.3d at 1330 (SILO transaction a "win-win situation" for all of the parties who

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[38] As noted above, BNY's half of the Trust tax was reduced by a time value of money factor on the assumption that BNY would receive the spread before Barclays received the U.K. credits.

[39] These amounts assume that all Trust income was nominally distributable to Barclays when, in fact, approximately one percent was distributable to Investco. The difference is immaterial to the substance of the transaction.

divided "free money" transferred "from the public fisc"); Pritired, 2011 WL 4552469 at *42 (rejecting structure designed to produce foreign tax credits attributable to assets French banks already owned as "complete creature" of the parties "who had the power to create whatever appearance would be of tax benefit to them despite the economic reality of the transaction"); Enbridge Energy Co. v. United States, 553 F.Supp.2d 716, 726 (S.D. Tex. 2008), aff'd, 354 Fed. Appx 15 (5th Cir. 2009)(describing the transaction as providing "the best of both tax worlds" and resulting in "definite tax benefits to all the parties involved"); Santa Monica Pictures v. Commissioner, T.C. Memo. 2005-104, 2005 WL 1111792 at *77 (finding participants' interests not adverse as to the transaction's tax characterization). BNY's diversion of more than $460 million annually to its wholly owned Trust had no substantive effect on its business and, indeed, BNY often failed even to observe the form of its new structure. The assets were

managed and controlled in the U.S. in precisely the same fashion before and after the transaction.

Rather than effect any real business transaction, the sole motivation for the STARS Trust structure was to create a large foreign tax liability for which U.S. foreign tax credits would be claimed, and simultaneously allow for the economic recovery of the tax expense in a manner that would not reverse the tax savings. Because BNY's income traveled in a pre-determined circle back to its origin in BNY's U.S. operations, the elaborate structure created by the parties had no economic effect beyond the creation of tax benefits. See Altria Group v. United States, 658 F.3d 276, 289 (2d Cir. 2011)(citing AWG Leasing v. United States, 592 F.Supp.2d. 953, 983 (N.D. Ohio 2008) (circular payments from and back to foreign bank "strongly indicate" that SILO transaction "has little substantive purpose other than generating tax benefits"); Merryman v. Commissioner, 873 F.2d 879, 882 (5th Cir. 1989)(tax structuring disregarded where "money flowed back and forth but the economic positions of the parties were not altered"); Professional Services v. Commissioner, 79 T.C. 888, 928 (1982)(disregarding prearranged circular cash flows through a trust).

Under both the economic substance and substance over form doctrines, the creation and use of sham structures like the STARS Trust and the other specially-created BNY STARS entities to achieve tax benefits are disregarded for federal tax purposes. E.g., Southgate Master Fund v. United States, 659 F.3d 461, 491-92 (5th Cir. 2011); ASA Investerings P'ship. v. Commissioner, 201 F.3d 505, 513 (D.C. Cir. 2000), aff'g T.C. Memo. 1998-305; National Inv. Corp. v. Hoey, 144 F.2d 466 (2d Cir. 1944); Long Term Capital Holdings v. United States, 330 F.Supp.2d 122 (D. Conn. 2004), aff'd, 150 Fed.Appx. 40 (2d Cir. 2005). Courts have consistently denied tax benefits produced by transferring assets to sham trusts. E.g., Zmuda v. Commissioner, 731 F.2d 1417 (9th Cir. 1984), aff'g 79 T.C. 714 (1982). Transfers to controlled trusts are disregarded as lacking in economic reality or substance where the taxpayer continued to control the transferred assets and its dealings with the assets were unchanged. E.g., Sparkman v. Commissioner, 509 F.3d 1149, 1155 (9th Cir. 2007); Markosian v. Commissioner, 73 T.C. 1235, 1240-41 (1980). BNY's transfers to and through its STARS Trust are no more substantive than the transfers disregarded in the sham trust cases.

The Stripping Transaction, which generated much of the foreign tax credits in the tax years before the Court, shows the manipulative, uneconomic nature of the Trust. BNY contends that this entirely internal transaction produced additional interest savings on borrowed funds. But the strip was just one more circular cash flow among related entities in which one BNY STARS entity (DelCo) bought interest rights from another BNY entity (the STARS Trust) using funds transferred to DelCo for that purpose by BNY Parent. This exchange of cash from BNY's right pocket to its left provides no economic basis for another $88 million in foreign tax credits.

B. BNY's Only Expected Benefit From STARS is the Tax Benefit Produced by the Trust Structure.

Courts apply the economic substance doctrine to the specific transaction or activity that generates the disputed tax benefit even if part of a larger set of arrangements. See ACM P'ship. v. Commissioner, 157 F.3d 231, 247-48 (3d Cir. 1998); Nicole Rose Corp. v. Commissioner, 320 F.3d 282 (2d Cir. 2003); Black & Decker Corp. v. United States, 436 F.3d 431 (4th Cir. 2006); Coltec Indus. v. United States, 454 F.3d 1340 (Fed. Cir. 2006). There can be no real dispute that the "double dip" tax benefit accomplished by the unit trust "building block" drove

all the STARS deals. Evidence concerning the development and marketing of STARS will show that the unit trust building block was included in every iteration of STARS. On the other hand, the alleged low-cost financing in BNY STARS was, in fact, one of several ways that Barclays considered sharing the recovered U.K. tax expense and was chosen for the tax structure as a marketing device.

The evidence will also show that STARS was designed to create tax benefits for both BNY and Barclays and was aggressively marketed by both Barclays' SCM and by KPMG tax partners to U.S. bank tax directors, including BNY's John DeRosa. The fact that STARS was a prepackaged marketed tax strategy is evidence that it lacked business purpose. Stobie Creek Inv. v. United States, 608 F.3d 1366, 1379 (Fed. Cir. 2010); WFC Holdings Corp. v. United States, 2011 WL 4583817 at *34 (D. Minn. 2011); Blum v. Commissioner, T.C. Memo. 2012-16.

In its STARS tax reporting, BNY characterized its recovery of half the U.K. taxes it paid under the Zero Coupon Swap (the spread amount) as a reduction in interest cost associated with a loan from Barclays that was added to the trust structure. It claims in the Petition to have benefited from STARS by avoiding

$50 million per year of interest expense (Pet. ¶ 5.A.(6)).[40] The issue for the Court is whether BNY can transform what is plainly a tax effect into an economic benefit by recasting the zero coupon spread amount as a 360 basis point reduction in what is otherwise an above market loan from Barclays.

BNY's proposed recast of the spread as negative interest is not supported by the facts or the tax law. The spread amount returned to BNY via the swap is not related to "compensation for the use or forbearance of money," Deputy v. du Pont, 308 U.S. 488, 498 (1940), and therefore cannot be a component of interest expense. BNY recognized that the spread was not a component of its cost of those funds in its internal management financial reporting. Moreover, BNY's characterization of its benefit from STARS as avoided interest expense does not stack up when

[40] From the time BNY began considering STARS through the filing of its Petition in this case, the only business purpose attributed to STARS was low-cost financing. Petitioner's trial experts have suggested several additional business purposes for STARS, including the nonsensical economic claim that $1.6 billion in profit that BNY would have earned from its U.S. assets whether or not it entered into STARS should be considered in evaluating the transaction's economic substance. Courts readily disregard after-the-fact rationalizations of disputed transactions in evaluating economic substance. Winn-Dixie Stores, 113 T.C. at 286; ACM, 157 F.3d 231, n.51; Schering Plough Corp., 651 F.Supp.2d at 270. In any event, as Respondent's expert rebuttal testimony will show, none of Petitioner's post hoc justifications withstand scrutiny.

examined from Barclays' perspective. Why would Barclays lend $1.5 billion to BNY, pay BNY negative interest and thereby lose $50 million per year? The answer is that it would not and did not. Coming from a large and highly sophisticated commercial bank like BNY, a story like this defies common sense. See Long Term Capital, 330 F.Supp.2d at 186 ("The absence of reasonableness sheds light on Long Term's subjective motivation, particularly given the high level of sophistication possessed by Long Term's principals in matters economic"). Unrebutted cash flow analyses prepared by both of Respondent's economic experts trace the entire benefit claimed by both BNY and Barclays from STARS to U.S. tax that BNY avoided by claiming foreign tax credits.

Once the spread payments under the Zero Coupon Swap are properly characterized as tax effects, BNY's purported justification of low-cost financing loses credibility. Economic and finance experts will testify that the non-tax terms of the financing -- the LIBOR + 30 bps. for an over-collateralized demand loan -- are materially worse than any plausible alternative. The evidence will show that BNY had no credible business reason to borrow $1.5 billion at the time and, even if

it had, it had ready access to interbank funds on substantially better terms and without substantial additional transaction costs. See ACM, T.C. Memo. 1997-115, 1997 WL 93314 at *39 ("Both the utility of the stated purpose and the rationality of the means chosen to effectuate it must be evaluated in accordance with commercial practices in the relevant industry."); ASA, 201 F.3d at 516 (the taxpayer could have realized its claimed business objective "at far, far lower transactions costs"). In sum, the evidence will prove that no credible banker in BNY's position would use the Trust structure as a means of borrowing funds, or would have borrowed the funds on these terms, in the absence of the claimed tax benefits.

Petitioner attempts to characterize its benefit from STARS as entirely attributable to U.K. tax benefits claimed by Barclays. Like Barclays' projections, Petitioner assumes that the U.K. tax imposed on the Trust must be taken at face value as the real tax cost of the transaction so that a 22% U.K. tax on the Trust gives rise to an equal amount of foreign tax credits. From there, Petitioner concludes that the incremental tax savings are achieved by Barclays in the U.K. But Petitioner assumes away precisely what this case is about: whether foreign

tax credits can be appropriately claimed in the U.S. By focusing solely on Barclays' tax effects, BNY simply ignores the tax effects of its participation in the transaction. Once all the tax effects of using the Trust are taken into account, it is apparent that the U.S. tax benefits provided the only value in STARS.

Even if the Court were to accept BNY's characterization of the spread as a reduction of BNY's interest expense or some other pre-tax benefit, BNY would lose money in the arrangement without the value of the foreign tax credits. If the recovered U.K. tax expense in the form of the spread is considered in testing STARS for economic substance, then the U.K. tax cost of obtaining the spread must likewise be considered. As the Fifth Circuit Court of Appeals explained, "[t]o be consistent, the analysis should either count all tax law effects or not count any of them." Compaq Computer Corp. v. Commissioner, 277 F.3d 778, 785 (5th Cir. 2001), rev'g 113 T.C. 214 (1999); see also Wells Fargo v. United States, 2011 WL 5417100 (D. Minn. 2011)(declining to rule that U.K. taxes may not be treated as a cost in testing a STARS transaction for economic substance, distinguishing the foreign tax credit transaction before the

court in IES Indus., Inc. v. United States, 253 F.3d 350 (8th Cir. 2001) as not using specially created entities and as involving market transactions).[41] The evidence will show that the U.K. tax effects, like the parties, work in tandem -- the payment of the Trust tax generates the offsetting tax effects on Barclays' tax return which, in turn, funds the spread payment to BNY. The spread cannot be considered in isolation from the U.K. tax payment that makes it possible. As long as foreign taxes are treated consistently for purposes of the analysis, the transaction fails as a low-cost borrowing. Any value attributed to the spread -- 50% of the tax cost -- is doubly offset by the foreign tax cost itself, which had to be paid in order to receive the spread. Without the benefit of the foreign tax credit, such a deal will always lose money. See Goldstein, 364 F.2d at 742 (paying 4% costs to earn back 2% is "purposeless activity").

[41] In Compaq, 113 T.C. 214, this Court treated foreign taxes as an expense in ruling that the same foreign tax credit transaction that was involved in the IES case lacked economic substance. The Fifth Circuit Court of Appeals reversed following the Eighth Circuit Court of Appeal's opinion in IES Indus., 253 F.3d 350, which held that foreign taxes should not be treated as an expense. No other Court of Appeals, including the Second Circuit, have considered this question.

If incorporating a loan into an arrangement were effective to assure entitlement to benefits generated by tax structuring, then every well-advised taxpayer could abuse the tax law with impunity as long as it simultaneously borrowed money. The courts have rejected this nonsensical result. Where a transaction contains a financing or investment feature, but also includes structuring solely to produce tax benefits, courts will apply the sham or substance over form doctrines and recharacterize or recast the transaction to disregard meaningless tax-driven features. E.g., Southgate Master Fund v. United States, 659 F.3d 461 (partnership basis shifting tax structure appended to an investment in distressed assets disregarded and transaction recast as a sale); Superior Trading v. Commissioner, 137 T.C. No. 6 (2011) (same); TIFD III-E, Inc. v. United States, 459 F.3d 220 (2d Cir. 2006) (foreign lender's purported investment in an investment partnership recast as a loan), remanded to 660 F. Supp. 2d 367 (D. Conn. 2009), rev'd, 666 F.3d 836 (2d Cir. 2012); Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011)(sale of swap payments recast as loan); Samueli v. Commissioner, 661 F.3d 399 (9th Cir. 2011)(disregarding securities loan added to a business

transaction); Del Commercial Props., Inc. v. Commissioner, 251 F.3d 210 (D.C. Cir. 2001)(disregarding addition of intermediary in financing to avoid withholding tax), aff'g T.C. Memo. 1999-411; Pritired, 2011 WL 4552469 (investment by U.S. bank and insurance company in partnership with foreign banks recast as direct loan between partners); Enbridge Energy Co. v. United States, 553 F.Supp.2d 716 (use of intermediary disregarded and transaction recast as a direct sale). Applying these authorities to STARS, once the purely tax-motivated elements of the Trust are disregarded, STARS is simply a pricey loan deposited in BNY's Cayman branch that provides no basis for claiming any foreign tax credits.

C. Judicial Doctrines are Considered in Applying Tax Treaties.

Tax treaties are applied to facts as determined under domestic law, including judicial doctrines. See Del Commercial Props., T.C. Memo. 1999-411 (citing Gregory v. Helvering, 293 U.S. 465, 470 (1935) and Johansson v. United States, 226 F. 2d 809, 813 (5th Cir. 1964)), aff'd, 251 F.3d 210; Aiken Indus. v. Commissioner, 56 T.C. 925 (1971). Whether the entire STARS transaction or the STARS Trust structure is disregarded, there was no substantive transfer of assets to a U.K. trust but rather

a circular flow of income through it by mere book entries. As recast for U.S. tax purposes, this income continued to be beneficially owned by BNY in the United States outside the U.K. taxing jurisdiction. The US-UK Treaty was inapplicable to resource the Trust income.

II. Expenses Incurred by BNY Solely to Claim Foreign Tax Credits -- Including Putative Taxes, Interest, and Other Transaction Costs -- Are Not Deductible.

The cost of purchasing and executing a transaction without economic substance or credible business purpose is not deductible for tax purposes. E.g., Winn-Dixie Stores, 113 T.C. at 294; see also Knetsch, 364 U.S. at 366 (disallowing interest deduction on grounds that expenses were a "fee for providing the facade of 'loans' whereby the petitioners sought to reduce their … taxes"); Klamath Strategic Inv. Fund v. United States, 568 F.3d 537, 549-50 (5th Cir. 2009). Amounts are not deductible as interest where incurred solely for tax reasons even if they are legally owed and paid to unrelated lenders. Goldstein, 364 F.2d 734; see also Lee, 155 F.3d 584; In re CM Holdings, Inc., 301 F.3d 96 (3d Cir. 2002); Wexler v. United States, 31 F.3d 117 (3d Cir. 1994); Sheldon v. Commissioner, 94 T.C. 738 (1990). Under these authorities, Respondent properly adjusted BNY's interest

deduction for the years in issue to disallow deductions for the financing costs claimed by BNY -- LIBOR + 30 basis points -- in the arrangement.

BNY's purported tax expenditures -- the 22% liability on the Trust income -- were incurred to secure a tax benefit and in any event do not reflect the real foreign tax imposed on the transaction. The only tax ultimately paid to the U.K. was the 3.3% tax collected with respect to Barclays' share of the benefit. Thus, the tax for which the deduction is sought is both grossly inflated and attributable to Barclays' activity, not BNY's. The Congressional purpose of section 164 cannot justify a deduction in such a case.[42] The remaining expenses at issue, including the $6 million fee BNY paid to KPMG, were incurred to purchase a tax product and plainly were not necessary and ordinary expenses incurred in connection with a trade or business under section 162.

[42] Moreover, to the extent that these expenses were considered foreign taxes for purposes of section 164, BNY is precluded from deducting them in the same tax year it claims credits for other taxes under section 275(a)(4).

III. STARS Foreign Tax Credits were Properly Disallowed Under Section 269(a).

Respondent exercised its authority to disallow the foreign tax credits generated by the STARS transaction under sections 269(a)(1) and (2). It is undisputed that in implementing the STARS transaction, BNY (REIT Holdings) formed and acquired control of InvestCo, and InvestCo acquired assets generating the income on which U.K. tax was imposed, in a section 351 transaction that constituted a specified acquisition for purposes of each of sections 269(a)(1) and (2). The issue before the Court is whether the "principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy." Section 269(a); see also Treas. Reg. § 1.269-3(a).

As discussed above, the evidence will show that the principal purpose of the acquisitions in STARS that trigger section 269(a) was tax avoidance and that the tax avoidance purpose outranked, and exceeded in importance, any other purpose for the acquisitions. Canaveral Int'l Corp. v. Commissioner, 61 T.C. 520, 536; Treas. Reg. § 1.269-3(a); Capri Inv. v.

Commissioner, 65 T.C. 162, 178 (1975); Stange Co. v. Commissioner, 36 T.C.M.(CCH) 31 (1977)(magnitude of tax savings considered); Army Times Sales Co. v. Commissioner, 35 T.C. 688, 704 (1961)(all facts and circumstances considered).

Section 269 is designed to prevent taxpayers from using those sections of the Internal Revenue Code that provide deductions, credits or allowances to evade or avoid federal income tax. Treas. Reg. § 1.269-2(a). Treas. Reg. § 1.269-2(b) provides that credits are unavailable in circumstances where allowing the credit would "distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate." The evidence will prove that the foreign tax credits that BNY claimed from STARS distorted its tax liability because the "essential nature" of STARS conflicts with Congress' basic plan and purpose for the foreign tax credit rules. According, Petitioner's STARS foreign tax credits also should be disallowed under section 269(a).

WITNESSES

Respondent may call the following witnesses. Respondent reserves the right to call rebuttal witnesses, to call any witness identified or called by Petitioner.

Fact Witnesses (Alphabetically):

Ian Abrahams *(Barclays): Managing Director & Co-Director of the Strategic Capital Markets (SCM) group.* Mr. Abrahams is expected to testify concerning SCM's development and marketing of Project STARS and other tax-advantaged transactions; Barclays' discussions and relationships with BNY, KPMG, and Sidley; the benefits and risks of Project STARS and the STARS transactions generally and specifically with respect to BNY; and the marketing and negotiation of the STARS transactions generally and specifically with respect to BNY. Mr. Abrahams is also expected to testify concerning Barclays' approval process for SCM transactions generally, and the approval of Project STARS in February 2000, BNY STARS, and other STARS transactions. He is expected to testify concerning Barclays' evaluation of STARS, capital and other regulatory issues, Barclays' STARS tax reporting, and discussions with the U.K. tax authority regarding its tax reporting.

Michael Bice *(BNY Bank): Attorney, Office of Legal Counsel (2001); Strategic Solutions Group (SSG) Member (starting in 2002).* Mr. Bice is expected to testify concerning discussions with Barclays, KPMG, and Sidley; BNY Bank's internal consideration of the BNY STARS Transaction, including benefits and risks; BNY Bank's relationship with Sidley; the negotiation and drafting of legal documents for the BNY STARS Transaction; the reporting and operation of the BNY STARS Transaction; the consideration by BNY and Barclays of a second STARS Transaction; and the extension of the BNY STARS Transaction.

Robert Brady *(BNY Bank): Vice President of Global Treasury, SSG Member.* Mr. Brady is expected to testify concerning discussions with KPMG and Barclays; BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks; his creation of a model of the BNY STARS Transaction and the financial projections and analyses that he prepared; SSG's role in the BNY STARS Transaction; the set up, implementation, reporting, and operation of the BNY STARS Transaction; and KPMG's role in the operation of STARS.

David Brockway *(KPMG): Partner-in-Charge of KPMG Washington National Tax (Washington, DC).* Mr. Brockway is expected to testify concerning KPMG's role in the development and marketing of Project STARS and other Barclays' structured tax-advantaged transactions; KPMG's role in the BNY STARS Transaction and STARS generally; communications with Barclays and BNY Bank; KPMG's marketing tax opinion for Project STARS and tax opinions for the completed STARS transactions, including the BNY STARS Transaction; and KPMG's relationships with Barclays and BNY Bank.

Craig Chapman *(Sidley Austin Brown & Wood): Partner, Banking Department.* Mr. Chapman may testify concerning Sidley's relationship with Barclays, Sidley's role in the development and marketing of STARS to BNY Bank and other U.S. banks; Sidley's role in the BNY STARS Transaction; communications with Barclays, BNY Bank, and other U.S. Banks; and the expected tax treatment of the BNY STARS Transaction. Mr. Chapman may also testify concerning preparation of the BNY STARS transaction documents, tax opinions, and the role of Sidley partner R.J. Ruble in the BNY STARS Transaction.

Robert Clemmens *(Barclays): Credit Officer, Capital Financial Institutions Group.* Mr. Clemmens may testify regarding Barclays' internal risk management processes and Barclays' evaluation of the risks of the BNY STARS Transaction and STARS generally.

Polly Coe *(Barclays): Managing Director & Chief Credit Officer.* Ms. Coe may testify regarding Barclays' internal risk management processes and Barclays' evaluation of the risks of the BNY STARS Transaction and STARS generally.

Gerard Colaluca *(BNY Bank): Vice President of Global Treasury & Head of SSG.* Mr. Colaluca is expected to testify concerning the activities of SSG with respect to the BNY STARS Transaction and other tax transactions; pre- and post-closing discussions with Barclays, KPMG, and Sidley regarding STARS; BNY Bank's internal consideration of STARS, including expected tax, accounting, regulatory and financial benefits and risks; the assets used in STARS; the reporting of STARS and other transactions; the operation of STARS; the consideration of a

second STARS Transaction; the possible extension of STARS; and the termination of STARS.

Shon Conley *(KPMG): Manager, KPMG Washington National Tax (Washington, DC).* Mr. Conley may testify concerning KPMG's role in the development and marketing of Project STARS and other structured tax-advantaged transactions, KPMG's role in the BNY STARS Transaction, communications with Barclays and BNY Bank, and the benefits and risks of the BNY STARS Transaction.

John DeRosa *(BNY Bank): Senior Vice President & Director of Taxes (through June 2002).* Mr. DeRosa is expected to testify concerning his role as director of taxes; KPMG's and Barclays' introduction of STARS to BNY Bank; pre- and post-closing discussions with Barclays, KPMG, and Sidley regarding STARS, including assets to be used in the structure; BNY Bank's internal consideration of STARS, including expected tax, accounting, regulatory and financial benefits and risks; BNY's reporting and operation of the BNY STARS Transaction; and other tax transactions that BNY considered or engaged in with Barclays and/or KPMG.

David England *(Bank of New York Trust & Depository Company, Ltd.) the U.K. Trustee.* Mr. England was deposed in the United Kingdom pursuant to T.C. Rule 81(d), and Respondent intends to submit portions of his deposition testimony to the Court pursuant to Tax Court Rule 81. Mr. England served as the U.K. Trustee for the Trust and testified regarding interactions between the Trustee, the Trust, BNY, Barclays, KPMG, and HMRC relating to the BNY STARS Transaction, as well to the various operational issues, responsibilities, and activities relating to the use of the Trust in connection with the BNY STARS Transaction.

Todd Gibbons *(BNY Bank): Head of Global Treasury & Chief Risk Officer.* Mr. Gibbons is expected to testify concerning BNY's assessment and management of risk; BNY's management of assets and liabilities, including those used as part of the BNY STARS Transaction; discussions with Barclays, including discussions relating to Barclays' evaluation of BNY's credit; BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks; and BNY's reporting of the BNY STARS Transaction.

Roy Gillig *(KPMG): Senior Manager (Boston, MA).* Mr. Gillig may testify concerning KPMG's role in STARS Transactions, including the BNY STARS Transaction, and work done for BNY concerning foreign tax credit limitations.

Kevin Glenn *(KPMG): Partner, International Corporate Tax Services (New York, NY).* Mr. Glenn is expected testify regarding his role in selling the BNY STARS Transaction to BNY Bank and other U.S. banks; KPMG's role in the BNY STARS Transaction; KPMG's role in developing and marketing other structured tax-advantaged transactions; communications with BNY Bank and Barclays; the preparation by KMPG of tax opinions, and the benefits and risks of the BNY STARS Transaction.

Carolina Gomez *(KPMG): Manager (New York, NY).* KPMG has advised Respondent that it cannot locate Ms. Gomez. If Ms. Gomez can be located, and she is called, she is expected to testify regarding her role and KPMG's role in the operations and management of the BNY STARS Transaction, including the development of internal policies and procedures.

Gerald Hassell *(BNY Bank): President.* Mr. Hassell is expected to testify concerning BNY Bank's internal consideration of the BNY STARS Transaction, including the expected tax,

accounting, regulatory, and financial benefits and risks; the reporting and operation of the BNY STARS Transaction; and BNY's relationship with Barclays and its consideration of SCM tax products.

Alkis Ioannidis *(Barclays): Director, SCM group*. Mr. Ioannidis was deposed in the United Kingdom pursuant to Tax Court Rule 81(d), and Respondent intends to submit portions of his deposition testimony to the Court pursuant to Tax Court Rule 81. Mr. Ioannidis worked with Sohail Sultan of Barclays' SCM group on the STARS prototype and all of the proposed and implemented STARS transactions, including the BNY STARS Transaction. Mr. Ioannidis testified about the development and marketing of STARS and the benefits and risks of the transaction. He also testified concerning documents, models, and financial analyses he prepared relating to the concept of STARS and the implemented transactions. He also testified about structural and operational aspects of STARS.

Eric Jaeger *(Barclays): Managing Director, Capital Financial Institutions Group (New York, NY)*. Mr. Jaeger is expected to testify concerning Barclays' relationship with BNY, including other business and structured transactions,

communications with BNY Bank and other U.S. banks concerning STARS and other SCM transactions; the benefits and risks of STARS; and Barclays' evaluation of BNY's credit.

Roger Jenkins *(Barclays): Managing Director & head of SCM group*. Mr. Jenkins may testify concerning SCM's development and marketing of Project STARS and other tax-advantaged transactions to BNY and other customers; Barclays' discussions and relationships with BNY, KPMG, and Sidley; and Barclays' relationship with BNY.

Michael Katovitz *(KPMG): Senior Manager, International Corporate Tax Services (New York, NY)*. Mr. Katovitz is expected to testify concerning KPMG's role in the development and marketing of Project STARS and other structured tax-advantaged transactions; KPMG's role in the BNY STARS Transaction, including the preparation of KPMG's tax opinion; communications with Barclays and BNY Bank and other STARS customers; and the benefits and risks of the BNY STARS Transaction.

Sally Kawana *(KPMG): Director in KPMG Structured Finance group (New York, NY)*. Ms. Kawana is expected to testify regarding her role and KPMG's role in the operations and

management of the STARS transaction and the development of internal procedures.

Victor Le *(BNY Bank): succeeded Scott O'Connell as SSG Controller (2005).* Mr. Le is expected to testify concerning the operation of the BNY STARS Transaction, including interactions with KPMG, KPMG UK, Barclays, and the UK Trustee.

Monique Lipton *(BNY Bank): Vice President & Assistant Tax Director (2001); Interim Director of Taxes after departure of Mr. DeRosa (beginning June 2002).* Ms. Lipton is expected to testify concerning discussions with Barclays, KPMG, and Sidley; BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks; the reporting and operation of the BNY STARS Transaction; including transfers and accounting; BNY's consideration of a second STARS transaction and other deals with Barclays or KPMG; and the preparation and review of BNY's federal tax returns.

Wilson Mastrandrea *(BNY Bank): Vice President of Global Treasury & SSG Member.* Mr. Mastrandrea is expected to testify concerning the activities of SSG; BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks; discussions with KPMG and Barclays; the set

up, implementation, and operation of the BNY STARS Transaction; and KPMG's role in the operation of the BNY STARS Transaction.

Thomas Mastro *(BNY Bank): Bank Comptroller.* If called, Mr. Mastro is expected to testify concerning BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks; the financial accounting treatment of the STARS Transaction; and the reporting and operation of the BNY STARS Transaction.

Scott O'Connell *(BNY Bank): SSG Controller until 2005.* Mr. O'Connell is expected to testify concerning bookkeeping entries and accounting issues relating to the assets and income involved in the BNY STARS Transaction and the operation of the BNY STARS Transaction, including interactions with KPMG, KPMG UK, Barclays, and the UK Trustee.

John Park *(BNY Bank): Senior Vice President of Financial Analysis & Regulatory Reporting.* Mr. Park is expected to testify concerning BNY's procedures for evaluating tax transactions, discussions with Barclays; the accounting treatment and reporting of the STARS Transaction; and BNY Bank's internal consideration of STARS, including expected benefits and risks.

Thomas Price *(BNY Bank): Treasurer & Executive Vice President of Global Treasury.* Mr. Price reported to BNY Bank CFO Bruce Van Saun. Mr. Price is expected to testify concerning the treasury function at BNY, including BNY's management of its assets and liabilities, BNY's liquidity position and funding sources, and SSG; discussions with Barclays concerning STARS and transactions generally; BNY Bank's internal consideration of the BNY STARS Transaction, including tax, accounting, regulatory and financial expected benefits and risks; the assets used in STARS; and the reporting of STARS and other tax advantaged transactions.

Thomas Renyi *(BNY Bank): Chief Executive Officer.* Mr. Renyi is expected to testify concerning BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks; the reporting of STARS; and BNY's relationship with Barclays and its consideration of SCM tax products.

David Schenck *(KPMG): Partner, KPMG Washington National Tax (Washington, DC).* Mr. Schenck is expected to testify concerning KPMG's role in the development and marketing of Project STARS and other structured tax-advantaged transactions; KPMG's role in

the BNY STARS Transaction; communications with Barclays and BNY Bank; and the benefits and risks of the BNY STARS Transaction.

John Scordia *(BNY Bank): Vice President of Financial Markets & Sector Controller of Corporate Treasury (until 2006).* Mr. Scordia is expected to testify concerning bookkeeping entries and accounting issues relating to STARS assets and income; and the operation of the BNY STARS Transaction.

Sohail Sultan *(Barclays): Director, SCM group*. Mr. Sultan was deposed in the United Kingdom pursuant to T.C. Rule 81(d), and Respondent intends to submit portions of his deposition testimony to the Court pursuant to T.C. Rule 81. Mr. Sultan was a developer of the STARS Transaction. He testified concerning the unit trust "building block" and the various iterations of STARS. He testified concerning SCM's collaboration with KPMG to further develop and market STARS and his role in marketing STARS transactions to U.S. banks and the BNY STARS Transaction in particular. Mr. Sultan testified regarding Barclays' approval process for STARS generally and specifically with respect to BNY other customers. He also testified about structural and operational aspects of STARS and its risks and benefits.

Anthony Tuths *(Sidley): Associate, Tax Department.* Mr. Tuths is expected to testify concerning Sidley's role in the development and marketing of Project STARS to BNY Bank and other U.S. banks; Sidley's role in the BNY STARS Transaction; communications with Barclays, BNY Bank, and other U.S. Banks; and the expected tax treatment of the BNY STARS Transaction, preparation of a tax opinion for BNY and other U.S. banks, and the role of Sidley partner R.J. Ruble in the BNY STARS Transaction.

Bruce Van Saun *(BNY Bank): Chief Financial Officer.* Mr. Van Saun now lives, upon information and belief, in the United Kingdom. If Petitioner calls Mr. Van Saun, or Respondent is able to subject him to process, Respondent expects Mr. Van Saun to testify concerning the approval of STARS, the risks and benefits of STARS, and BNY's relationship and discussions with Barclays concerning the BNY STARS Transaction and other tax products.

Gregory Warnke *(BNY Bank): Vice President in Financial Analysis & Regulatory Reporting function (2001); Manager of International & Subsidiary Accounting (starting in 2004); Sector Controller of Corporate Treasury (starting in 2006).* If called,

Mr. Warnke is expected to testify concerning BNY Bank's internal consideration of the BNY STARS Transaction, including expected benefits and risks and the reporting and operation of the BNY STARS Transaction.

Mary Ann Watt *(BNY Bank): Senior Vice President of Financial Markets Credit Risk.* If called, Ms. Watt is expected to testify concerning BNY's measurement, evaluation, and reporting of counterparty and market risk at BNY, including risk associated with the STARS. Ms. Watt may also testify concerning the operation of and internal audit of SSG.

Anthony Zangre *(BNY Bank) and/or* ***Kevin Peterson*** *(BNY Bank): BNY Bank employees responsible for federal tax audit of BNY.* If one or both of these individuals are called, they are expected to testify regarding Information & Document Responses (IDRs) and other statements about the BNY STARS Transaction made during the course of Respondent's audit of BNY.

Custodial Witnesses

American International Group, Inc. (AIG): AIG was identified by a representative of Barclays as having considered but rejected the initial concept of the STARS transaction. Respondent may call a custodial or testimonial witness from AIG

to testify concerning this topic.

Barclays: Respondent may call a custodial witness from Barclays to testify concerning documents and records produced by Barclays. Respondent may also, in lieu of testimony, offer a certification from Barclays pertaining to such records.

Ernst & Young *(E&Y):* A witness from E&Y may testify concerning E&Y's unsuccessful efforts to locate its documents relating to the BNY STARS Transaction in the event that the parties are not able to agree to a stipulation concerning this matter. In addition, E&Y may be subpoenaed to testify regarding documents related to a project they undertook involving STARS.

E&Y has refused to identify the partners involved in auditing BNY's financial statements and Respondent has been unable to secure this information through pretrial discovery of Petitioner. To the extent this information becomes known and relevant at trial, Respondent reserves the right to call the lead engagement partner, auditor, and/or any other knowledgeable witness competent to testify concerning E&Y's audit of BNY's financial statements for the years at issue, and in particular, any review by E&Y of the treatment and reporting of the BNY STARS Transaction for financial accounting purposes.

***KPMG*:** Respondent may call a custodial witness from KPMG to testify concerning documents and records produced by KPMG. Respondent may also, in lieu of testimony, offer a certification from KPMG pertaining to such records.

Microsoft Corporation *(Microsoft)*: Microsoft was identified by a representative of Barclays as having considered but rejected the initial concept of the STARS transaction. Respondent may call a custodial or testimonial witness from Microsoft to testify concerning this topic.

Prudential Life Insurance Co. *(Prudential): Prudential* was identified by a representative of Barclays as having considered but rejected the initial concept of the STARS transaction. Respondent may call a custodial or testimonial witness from Prudential to testify concerning this topic.

Sidley: Respondent may call a custodial witness from Sidley to testify concerning documents and records produced by Sidley. Respondent may also, in lieu of testimony, offer a certification from Sidley pertaining to such records.

Yahoo! Inc. *(Yahoo)*: During the taxable years at issue, Mr. DeRosa conducted business on behalf of the BNY through the use of his personal email address with Yahoo. Yahoo is the

custodian of records for such emails. Respondent may subpoena and call a representative of Yahoo to testify concerning relevant business emails sent by Mr. DeRosa from his personal email address.

Expert Witnesses

The following experts will testify on behalf of Respondent concerning the matters addressed in their opening and rebuttal reports and will offer surrebuttal testimony as appropriate.

Michael Cragg. Dr. Cragg is an expert in economics and finance. In his opening report, Dr. Cragg concludes:

(1) that in the absence of economic benefits generated from the U.S. tax system, STARS was not profitable;

(2) that the economic profit from STARS arises solely because BNY claimed roughly $500 million in foreign tax credits without bearing the full cost of the foreign taxes involved;

(3) that STARS had two functional parts: a trust structure that generated the foreign tax credits, and a financing component that could have been accomplished more efficiently and served merely as a vehicle for distributing tax benefits to BNY;

(4) that the loan aspect of STARS is only profitable when foreign tax credits generated from the trust are creditable;

(5) that, in comparison to a typical financing transaction, STARS both nominally and on a net present value basis, STARS offered no reasonable possibility of profit on a pre-tax basis;

(6) that it would have been economically irrational for BNY to enter into STARS without the foreign tax credits generated through the trust; and

(7) that the Stripping Transaction only accelerated the tax benefits of STARS and created no pre-tax value.

Dr. Cragg also prepared a rebuttal export report in which he addresses the errors in the reports of Petitioner's experts Dr. Atherton and Dr. Hanweck.

David Ross. Mr. Ross is an expert in economics and finance. His opening report is based on an economic analysis of a financial model of STARS provided to BNY by Barclays. Mr. Ross concluded:

(1) that if BNY is entitled to foreign tax credits, STARS would be expected to benefit BNY and Barclays, and if BNY was not entitled to the foreign tax credit, the BNY transaction would have been economically detrimental to BNY;

(2) that the benefits of STARS arise solely from a reduction in U.S. taxes only partially offset by an increase in U.K. taxes; and

(3) that it would not have been rational for BNY to participate in STARS without the possibility of obtaining foreign tax credits.

Mr. Ross also prepared a rebuttal expert report in which he addresses the errors in the reports of Petitioner's experts Dr. Atherton and Dr. Hanweck.

Steven Schwarcz. Prof. Schwarcz is an expert in structured finance. In his opening report, Prof. Schwarcz concludes:

(1) that, in light of its economic characteristics, STARS was excessively complex, utilizing a number of special purpose entities;

(2) that the STARS loan was not commercially reasonable because it allowed for a commercially untenable negative interest rate; and

(3) that various aspects of STARS were inconsistent with typical structured finance transaction, which, unlike STARS, efficiently allocate risk and reduce information asymmetry.

Mr. Schwarcz also prepared a rebuttal expert report in which he addresses the errors in the report of Petitioner's expert Dr. Atherton.

Edward L. Cipullo. Mr. Cipullo is an expert in banking, particularly in asset, liability, and liquidity management. In his opening report, Mr. Cipullo explains the various means employed by banks in raising capital, examines the market conditions and BNY's financial position during the relevant period, and concludes:

(1) that despite a weakening economy, there was a significant amount of liquidity in the financial markets during 2001;

(2) that BNY had the ability to raise additional funds in excess of the amount of the STARS loan at a rate of LIBOR or below;

(3) that BNY would have sufficient access to US dollar funding markets to raise short term liabilities at LIBOR or below LIBOR; and

(4) that BNY had sufficient short term liquidity on-balance sheet to absorb an increase in assets of $1.5 billion without issuing additional liabilities.

Mr. Cipullo also prepared a rebuttal expert report in which he addresses the errors in the report of Petitioner's expert Dr. Hanweck by accepting as true the details and representations in Dr. Hanweck's expert report and challenging the correctness of the conclusions Dr. Hanweck draws therefrom.

Anthony Saunders. Prof. Saunders is an expert in banking and financial markets. In his opening report, Prof. Saunders concludes:

(1) that STARS was not a standard banking transaction;

(2) that when the spread (i.e., the amount of tax benefit Barclays rebated on a monthly basis to BNY) is included in computing the interest rate on the loan, the loan is commercially unreasonable to Barclays and is not a loan that would be undertaken in the normal course of banking activities;

(3) that the pricing of STARS does not appear to reflect the risks and other characteristics associated with the transaction; and

(4) that there is no commercial or economic justification for Barclays as the lender to pay BNY to borrow Barclays' money.

Prof. Saunders also prepared a rebuttal report in which he addresses the errors in the reports of Petitioner's experts Dr. Atherton and Dr. Hanweck.

Philip Baker. Mr. Baker is a barrister and Queen's Counsel and an expert in U.K. tax law. In his expert report, Mr. Baker:

(1) describes the underlying U.K. statutory provisions related to the taxation of the Trust; and

(2) describes Barclays tax reporting of the STARS transaction, including the Stripping Transaction.

Respondent intends to ask the Court to allow Mr. Baker to rebut at trial additional testimony presented by Petitioner's U.K. tax law expert in a second report if the Court does not exclude the additional testimony. See discussion of Ghosh Motion in Limine below.

EVIDENTIARY ISSUES

Hearsay Objections. In the Second Amended Stipulation of Facts, Petitioner has reserved hearsay objections to 129 stipulated exhibits. In a supplemental stipulation of facts, currently being negotiated by the parties, Petitioner has thus far indicated its intent to reserve hearsay objections to approximately 77 documents.

Petitioner's hearsay objections relate mostly to communications, largely emails, between and among employees of Barclays, KPMG, Sidley, and BNY. Respondent has requested that Barclays and KPMG certify these documents as business records. To the extent documents are not so certified, Respondent expects to lay a foundation for the admission of the documents through testimony that these documents were contemporaneously prepared and maintained in the ordinary course of the operations of Barclays, KPMG, and Sidley and are therefore business records. See Fed. R. Evid. 803(6). In certain circumstances, Respondent may offer the documents for non-hearsay purposes and not necessarily for the truth of the matters asserted therein.

Respondent continues to maintain that Petitioner's wholesale objection to every third-party document proposed by stipulation violates T.C. Rule 91. See Respondent's Motion for PreTrial Conference filed on December 15, 2011. The bedrock of Tax Court practice is the stipulation process. Branerton Corp. v. Commissioner, 61 T.C. 691, 692 (1974). T.C. Rule 91(a)(1) requires the parties "to stipulate, to the fullest extent to which complete or qualified agreement can or fairly should be reached, all matters not privileged which are relevant to the

pending case, regardless of whether such matters involve fact or opinion or the application of law to fact." The Rule expressly requires stipulation not only of all facts but also "all documents and papers or contents or aspects thereof, and all evidence which fairly should not be in dispute."

Complete or qualified agreement fairly should be reached by the parties in this case on whether stipulated documents kept by KPMG, Barclays, and the participants' lawyers relating to the BNY STARS transaction are records of regularly conducted activity that meet the business record exception to the hearsay rule in Fed. R. Evid. 803(6) or another exception to the rule. Attorneys can reasonably disagree over whether a particular document is a business record. But it cannot be true that none of Barclays' documents regarding what Petitioner characterizes as a $1.5 billion financing from a large and highly-regulated financial institution qualify as a business record.[43] Nor can it be true that none of the documents about STARS that are

[43] Petitioner has also questioned whether e-mails are business records. For years now, business has been conducted via e-mail and courts have recognized that e-mails can be business records. See e.g., United States v. Stein, 2007 WL 3009650 (S.D.N.Y.).

maintained by KPMG, one of the largest accounting firms in the world, qualify as a business record.

Relevancy Objections. Petitioner has also reserved relevancy objections to 52 stipulated exhibits and to 19 paragraphs in their entirety and four paragraphs in part.[44] The relevancy objections relate mostly to documents related to the development and marketing of the STARS transaction by Barclays and KPMG. These STARS prototype materials are highly relevant given that SCM, in presenting the BNY STARS Transaction to Barclays' internal product and credit committees for approval, expressly referenced Barclays Capital's prior approval of the STARS prototype.[45] It is well established that the motives and activities of the promoters and developers of a transaction are relevant in determining its substance. TIFD IE-III, 342 F.3d at 225-29; ACM, 157 F.3d at 233-44; Compaq, 113 T.C. 214, rev'd on other grounds 277 F.3d 778; Pritired, 2011 WL 4552469, at *3-*14; WFC Holdings, 2011 WL 4583817, at *4-*13; Fid. Int'l Currency Advisor A Fund, LLC v. United States, 747 F. Supp. 2d

[44] Consistent with the agreement of the parties set forth in the preamble to the Second amended Stipulation of Facts, Petitioner identified its relevancy objections in a letter dated March 6, 2012.

[45] Ex. 365-R at BBPLC00272869.

49, 229 (D. Mass. 2010); see also Independent Elec. Supply, Inc. v. Commissioner, 781 F.2d 724, 729 (9th Cir. 1986); Simon v. Commissioner, 830 F.2d 499, 507 (3d Cir. 1987).

Ghosh Rebuttal Report. Respondent intends to file a Motion in Limine to exclude the Rebuttal Report submitted by Petitioner's U.K. law expert Julian Ghosh. Rather than confining his rebuttal report to addressing the opinions expressed in the reports of Respondent's experts, Mr. Ghosh "clarifies" and elaborates on matters addressed in his opening report, including topics that were not addressed in the opening report of Respondent's U.K. tax expert. Accordingly, Mr. Ghosh's second report is not a rebuttal expert report but rather untimely case-in-chief testimony. Alternatively, Respondent intends to ask the Court to allow Respondent's U.K. tax expert to rebut Mr. Ghosh's second report at trial.

Cipullo Rebuttal Report. Petitioner filed a Motion in Limine to exclude testimony of Respondent's bank treasury expert Edward L. Cipullo in rebuttal to Petitioner's expert Gerald Hanweck. In his rebuttal report, Mr. Cipullo accepted facts about the STARS transaction presented by Mr. Hanweck in Mr. Hanweck's opening report and disagreed with the conclusions Mr.

Hanweck reached based on those facts. Respondent submits that Mr. Cipullo's testimony is entirely proper rebuttal expert testimony and intends to file a Notice of Objection to Petitioner's Motion in Limine.

Docket No. 26683-09

Respectfully submitted:

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Date: 3/27/12

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CERTIFICATE OF SERVICE

This is to certify that a copy of the foregoing RESPONDENT'S TRIAL MEMORANDUM was served on counsel for Petitioner by mailing the same on March 27, 2012 in a postage paid wrapper addressed as follows:

B. John Williams, Jr.
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